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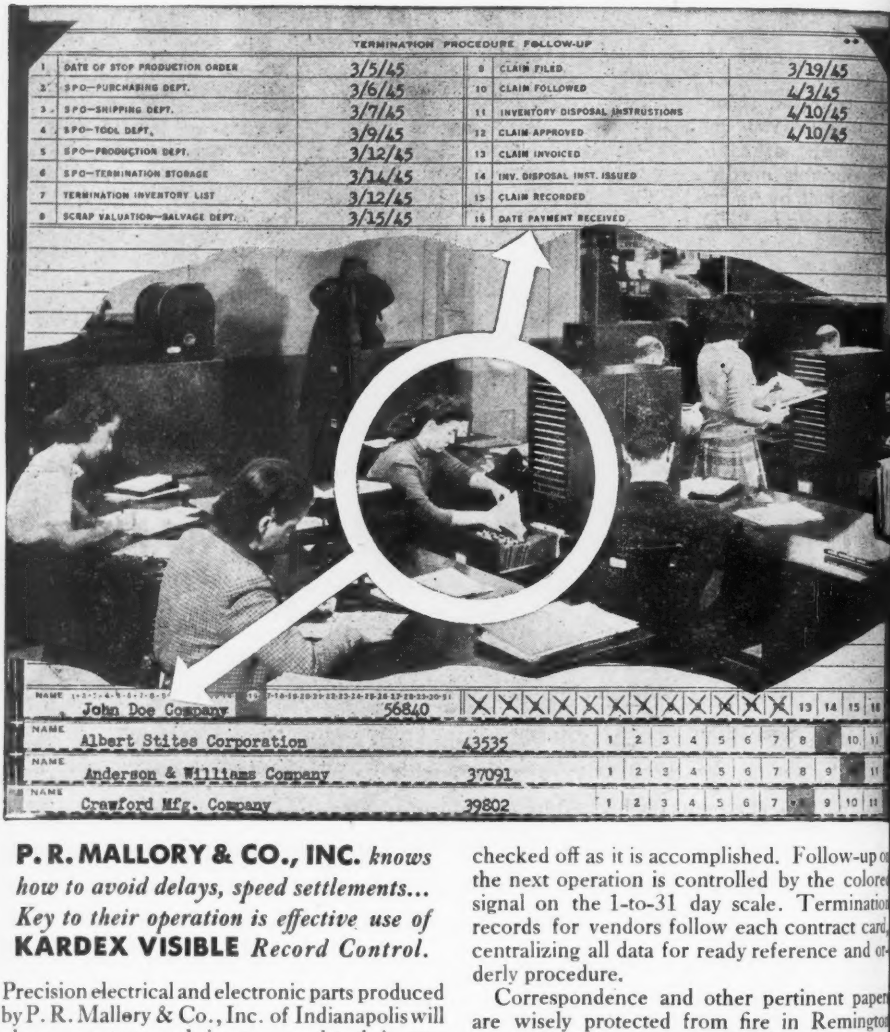

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VOL. XV — *July : 1945* — NO. 7

The Business of Peace

By SAMUEL J. BROAD, C.P.A.

WE have just completed a major part of the war and the stupendous nature of our victory thrills our souls. But we cannot afford to coast until V-Day arrives. Our full energies must be, and are, directed to the completion of the task. We can look forward to total victory with so much confidence, however, that we are justified in looking a little farther ahead and planning for the very difficult problems which the cessation of hostilities will bring. The problems of peace should not find us unprepared.

The history of the Western nations has been a series of struggles for individual freedom. The religious debates and struggles of the 16th century were followed by the political struggles of the 17th and 18th centuries. The inventions and scientific developments of the 19th century were so revolutionary that they changed the nature of the struggle; it became an economic struggle. Machinery destroyed the self-dependence of the individual. The developments in transportation—the railroad, the steamship, and the airplane—and in communications—the telegraph, the telephone and the radio—have destroyed the limitations of time and space, first between different sections of a nation, and later between nations themselves. Let us imagine ourselves deprived of transportation, or without telephone and telegraph service . Government and business would soon be in chaos. Cities would soon starve.

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Cooperation

This inter-dependence has placed tremendous power, and tremendous capacity for harm, in the hands of economic groups. A high degree of organization, if combined with selfish insistence on advantage to the group and disregard for the common welfare, could do untold injury. Such insistence would turn into economic war on democracy, and if it should prove successful democracy will fail to function. Cooperation must be our watchword. Democracy cannot succeed without it.

In international affairs we learned cooperation the hard way. It came

slowly at first but as the war progressed self-preservation forced it upon the Allied nations, ourselves included. A degree of military and political cooperation between nations has been attained, the like of which has never before been seen in the history of the world. We are making a good start towards the even harder task of planning cooperation for peace.

The outset of the war found government and business in our country with wide divergences of opinion on important questions. In the nation's crisis business and government also learned to cooperate, and the result was the stupendous war production which amazed the world, and amazed even ourselves. In the difficult task of planning and establishing a workable peace, this cooperation between business and government must continue.

Groups within business must learn to cooperate too. A promising start was made recently in the joint statement issued by representatives of employers and labor. It was perhaps a statement of objectives and it left many points unsettled. But the very fact that a start has been made is promising. Cooperation is a hard road and those who walk it deserve every encouragement in their progress.

National Income

The primary interest of all should be to make democracy work. Economically this objective requires full employment at good wages. Full employment means not merely jobs, but productive jobs. It is hard to recognize any increase in the national income when a man breaks his arm and has to pay a doctor's bill, or when he runs his automobile into a lamp post and has to pay a garage bill. Both result in income to someone but it is merely a transfer of dollars without any increase in the total national income. Full employment, again, does not mean that everyone who has ever worked for wages should continue to do so. In times of normal prosperity the young, the old, the homemaker, should preferably be at school or at home, engaged in their normal pursuits. Eventually this will reduce the number employed. For a time those affected may be drawing unemployment compensation and for this reason statistics on unemployment in the near future will have to be regarded with caution.

Production is the best measure of prosperity, and continued production requires equivalent consumption. The background for a high level of production and a high level of consumption must be confidence—confidence on the part of the producer that he will be able to sell at a reasonable profit and confidence on the part of the consumer that he will continue to earn a good livelihood. Consumption is the only real limit to production. There is no limit to possible consumption, and that quite apart from the present backlog of unfilled wants. The actual limit of consumption is reached when the sacrifice necessary to pay for more goods exceeds the desire to consume them. And when this sacrifice by the consumer carries with it possible lack of security in the future it will quickly outweigh the desire to consume.

Similarly, business men will expand their plants and buy new machinery only if they feel secure in the expectation of profitable markets for additional products.

This sense of confidence or security must be created and maintained, because only by the increased production and the increased consumption which it will bring can we achieve a balanced budget and the orderly retirement of our public debt.

Requirements for Confidence

What is the climate under which such confidence an be expected to

thrive? The fundamental requirement is cooperation—cooperation between all elements of our community, between government and business, and between the different groups which constitute business. Fortunately we have always had freedom of opportunity in America. Our objective must be equality of opportunity, an objective which we have always sought but have not fully attained. We should have free and equal access to materials and markets. We must seek the greatest possible freedom of trade and commerce. To this end restrictive practices—monopolistic practices—on the part of both management and labor, which result in the unnecessary raising of costs, must be eliminated. Payments which increase costs without adding anything of productive or service value are arbitrary barriers hampering the free flow of production and trade.

Small Business

Our prosperity must be founded on the broad base which such equal opportunity creates. Conditions conducive to the success of small business must be provided because of the major role it plays in our national economy. Statistics (for a pre-war year) quoted by a committee of the American Bankers Association show that 60% in number of all enterprises had a net worth of less than $3,000 each and 95% net worth of less than $200,000 each; also that 45% of all persons gainfully employed in industry and trade, in 1939, were employed by small business. Conditions favorable to small business are of particular moment at the present time because of their impact on the returning veteran in terms of his future as a proprietor of small business. A release by the War Department reports that 7% of men now in the army plan to conduct their own businesses after the war. And finally small business is the father of large business, the source from which it springs.

Favorable conditions cannot of course guarantee the success of small business; ability and know-how are necessary too. But if the conditions are favorable the better prospect of success will supply the confidence needed to induce new ventures.

First and foremost is the need for simplification and modification of our tax laws. The proposal to increase the excess profits tax exemption should be made effective. This would eliminate excess profits taxes for most small enterprises and make their taxes roughly equal to those paid by individuals on the same income. Double taxation of corporate dividends should be eliminated as soon as possible. Credit should be made readily available to those deserving it. This applies particularly to returning veterans who are entitled to help in making up for lost time. Loans should be made, however, on a business and commercial basis and not on a basis so risky that in effect they constitute gifts. Accounting help and advice will be required by veterans starting up business afresh and the American Institute of Accountants is seeing what can be done to make such help readily available. Finally, free access to materials requires fairness and full information in the disposal of surplus government properties.

Government Accounting and Auditing

Government, in its relations to the people, is in a position similar to that of the management of a corporation to its stockholders. It is the duty of business management to operate efficiently and to keep the owners informed so that they can judge the achievement and ability of the management, and also the progress made. The tools of management are per-

sonnel, and contact is maintained with the owners through periodical reports. These should be clear and informative, and be supported by audits where financial transactions are involved. Our government has the same duty, to operate efficiently and report clearly, and it is no exaggeration to say that it needs a good deal of streamlining in both respects.

Some of our government departments do submit informative reports. Outstanding examples are the reports which the War and Navy Departments have issued from time to time dealing with the progress of the war. They have been objective, setting forth accomplishments, and they have given us every confidence in the management of our war effort. At the other extreme is the government's financial reporting. Though operating the largest business in the world, with more accounts probably than any other organization, accounts usually kept accurately even if in unnecessary detail, the government does not have a coordinated, efficient and informative accounting system; and there is no single comprehensive financial statement or report which summarizes the financial transactions or position of the United States Government as a whole.

Further, the United States Government does not have an auditing system which measures up to present business standards. Though meticulous in detail the audit is essentially what public accountants would describe as a cash or voucher audit, being more or less limited to the legality of the payments and the accountability of the disbursing officer. It does not answer other questions just as important, perhaps more important; questions such as "What have we got to show for our money?" or "What happened to the goods we paid for?" or "What is the financial position?" To answer such questions a different kind of an audit is required and one made in the field where the operations are carried on.

Financial reports and audits of the character made by the Government would not be accepted from business by bankers who lend their money, or stockholders who provide the capital, or stock exchanges where securities are bought and sold. Nor would either the accounting or the auditing meet the standards which Congress has set up under the various Securities Acts for the information and protection of investors.

The American Institute of Accountants, through its sponsorship of meetings and conferences, has sought vigorously to improve this situation, and with some success. Recently at the request of Senator Byrd we took the initiative again in organizing an informal committee, made up of leading Government officials and members of our committee on governmental accounting, to assist a Congressional Joint Committe interested in this subject. Under a recent amendment to the George bill —the so-called Byrd amendment— the Comptroller General was authorized and directed annually to examine the accounts of all Government corporations, his examination to be made "in accordance with principles and procedures applicable to commercial corporate transactions". More elaborate legislation of the same pattern is presently being considered by Congress. If the prescribed audit of Government corporations can be made effective and adequate it seems likely that Government departments will be subject to similar audits, more far reaching and effective though less detailed, than those made heretofore.

The Comptroller General is very much alive to the added responsibility which has been placed upon him. He is actively engaged in building up an organization of trained and qualified people for the division which is to carry on the work, and

in this the American Institute of Accountants has made intensive efforts to assist him. With his encouragement we have also appointed a committee which will be available to help in any way it can.

Government Organization

The organization of our Government also is in many respects similar to that of a well organized business. The executive function is carried on by officials who head up to the President. Congress is the board of directors which, working closely with the President, should settle and control policies. Under the President are the many departments, sub-departments and agencies through which the activities of government are carried on.

Given a good plan of organization the fundamental requirement for good management is personnel—personnel of ability, integrity and adequate training. The experience of certified public accountants gives them exceptional opportunities to observe this. Their professional activities year in and year out take them right into the heart, into the inner secrets, of one business after another. It is their duty to find out what goes on and how it is accomplished. They cannot help but realize how important is the contribution which competent management and qualified personnel can make to the success of a business.

Another thing which certified public accountants realize is that high salaries or high wages do not necessarily mean higher costs. Greater efficiency and ability may result in lowering costs and this is particularly true in the case of administrative people who work with their brains rather than their hands, and direct the work of others.

Congress

Good organization and good management are just as important in the field of government as in the field of business. Let us look at our government with this thought in mind; and first Congress, the board of directors.

There is a real need for Congress to streamline its organization and its procedures; to make its committee and investigating activities as efficient as possible; and to adopt some means more effective than the seniority rule for important appointments. In the recent crisis the leaders of our armed forces were chosen for fitness and ability; length of service had to go into the discard. We would have accepted no other course. Business too selects its leaders for proven qualification and initiative, not seniority, or it loses its place in the race. Vital years are ahead and the needs of the country demand that Congress follow suit.

As to personnel, the remuneration of members of Congress makes many qualified people unavailable. Members of Congress are very much underpaid for the ability needed to meet adequately the responsibilities which are theirs. The salary of a Senator or Congressman is $10,000 a year, an amount which was probably adequate in 1925 when it was fixed, and when it could be augmented by other remunerative work. Today a conscientious Senator or Congressman has a full time job and little time and energy left for outside activities. Moreover, the cost of maintaining one residence in his home state and another in Washington, of keeping in touch with constituents, and of assistance and travel over and above the allowances granted cuts heavily into his salary.

The position should be made attractive to the ablest men in the country. The salary should be at least $15,000 a year. The determination of the amount, $15,000 or some other figure, deserves serious consideration, regardless of whether it be made effective immediately or when present salary restrictions are

removed. And we should not stop with salaries. Adequate expense allowances should be provided, but they should be supported by a statement of expenditures if running above a certain minimum. An arbitrary increase in expense allowances savors of the backdoor approach. The salary and expense issues should be faced squarely, and dealt with on their merits.

Civil Service

The remuneration of men in key positions in the various government departments and agencies is also unduly limited. It is frequently much less than that commanded by those charged with similar responsibilities in private business. Men of great ability, sincere purpose and real devotion to the public interest occupy many of these key positions. But too many of them leave to accept private employment where the financial rewards and financial prospects are more attractive.

When we buy quality we usually get what we pay for. If we are not willing to pay the price somebody else gets it. Strong leadership, able administration and effective control soon make themselves felt throughout a department. They not only improve the morale; in the long run they result in real economy. The cost of government should be reduced rather than increased by the greater efficiency which would result from top-grade personnel in key positions.

The position of chief of the new audit division in the General Accounting Office to which I have referred is a good illustration. Congress inserted a clause in the legislation which permitted the Comptroller General to select ten men for this department without regard to the civil service classification act. The salary of the chief of the division is limited to $10,000 per annum. The Comptroller General asked and received nominations for the position from the American Institute of Accountants. The position demanded a man of great organizing ability, sound judgment and wide professional experience. A man qualified to undertake a task of such magnitude could probably earn an income of at least $25,000 a year in private practice. A young man of proven ability but limited resources might well consider the financial prospects too restricted. Most older men in stronger financial positions might consider the task more arduous than attractive. As a result, the choice was very considerably narrowed.

We should be able to attract to important positions in the government people of recognized ability; and to keep in the public service men the value and effectiveness of whose services has been demonstrated. We must make the key positions in our civil service more attractive. To adequate compensation should be added security of position. Freedom from political interference must be assured, in fact as well as in theory. The remuneration should approach that paid by business so that the difference is reasonably compensated for by security of position and the prestige and satisfaction which come from public service. We should make our civil service sufficiently attractive as a career that able, aggressive and ambitious young men will not hesitate to make it their life's work. There are several hundred men occupying key positions in the government whose top salary is $8,000 to $10,000 a year. It should not be so limited; a man should be paid what the job he is doing is worth; if some maximum is necessary it should be not less than $25,000.

Taxation

Business confidence and the higher level of employment which it creates will be materially advanced

by increased efficiency in the management of national affairs. Another requisite is to strengthen the profits motive on which our economy is based. Under our scheme of government the major incentive to produce, to work hard, and to take risks, is the hope of reward in the form of profits or compensation.

Early in the war as a nation we adopted the policy of keeping the profits out of war. By means of high tax rates and renegotiation, generally speaking this has been accomplished. As a result our tax system is geared to war requirements. For peacetime purposes it must be revised; taxation must be returned to levels which leave enough of the incentive to encourage effort and investment.

Changes in line with this policy should become effective promptly upon cessation of hostilities. To accomplish this there is urgent need for the establishment by Congress of a coordinated long range tax policy. Congress should appoint a nonpartisan tax commission to study the subject and bring in recommendations. The alternative is to patch up again our present tax laws—laws which already are so cumbersome and so intricate that even those who have spent a lifetime in tax practice are often unable to ascertain what the tax liability is.

Tax policies are being studied by the Congressional Joint Committee on Internal Revenue Taxation and progress is being made. Valuable time has already been lost, however, and the inevitable preoccupation of Congress and the Government departments involved with other important matters leaves some doubt as to how effectively the job can be done without making it a full time project, instead of a side line. Looking ahead, a sound tax policy is one of the most pressing matters demanding the attention of Congress if we are to have constructive and aggressive action by business upon completion of the war.

Tax Simplification

With regard to tax simplification, a great deal has been accomplished in the case of income tax returns of individuals. Simplification of corporate tax returns is a more difficult matter if inequities are to be avoided; but a large measure of simplification is practicable and should be undertaken. The income tax is supposed to be a tax on income. Under the Internal Revenue Code, income is to be computed in accordance with the method of accounting used by the taxpayer, with the proviso that if this method does not clearly reflect income the computation is to be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income.

Income is an economic concept. But the tax law and regulations and their interpretation by the courts seem to be moving farther and farther away from the economic concept of income, towards an arbitrary and legalistic concept which is quite different. In a recent decision, for example, the full proceeds of sales of coupon books were held by the Tax Court to be income in the year in which the money was received, regardless of the fact that the services which the coupon issuer must furnish were to be performed, and the costs sustained, in later years. The Bureau of Internal Revenue has issued a ruling which says that retroactive wage increases paid may be deducted only in the year in which an uncontested application for approval by the National War Labor Board is filed. The fact that the wages may have been costs of a prior year is disregarded. Such decisions are based entirely on form and disregard reality.

One of our Senators stated recently that "Congress is a force that is just as valid in fixing what a cost

accounting method as the practices of business". Neither the law nor the practices of business can change costs from what they are, or create income. Nor can accounting. Congress may say that for tax purposes special deductions may be taken for amortization of war facilities, or that depreciation deductions may be increased for a period of years. This does not make the deductions a cost of doing business. It reduces the balance on which taxes are payable but does not reduce the real income. Such allowances may be desirable as an incentive to induce taxpayers to take a specific course of action; but they should be recognized frankly as special deductions permitted in order to compensate for abnormal costs of construction under war conditions. Income exists by and of itself; it can be determined only in accordance with objective and recognized standards; it cannot be increased, or decreased, by fiat. Our tax laws should revert to the original concept of the income tax, namely, that it is a tax on income.

Government Regulation

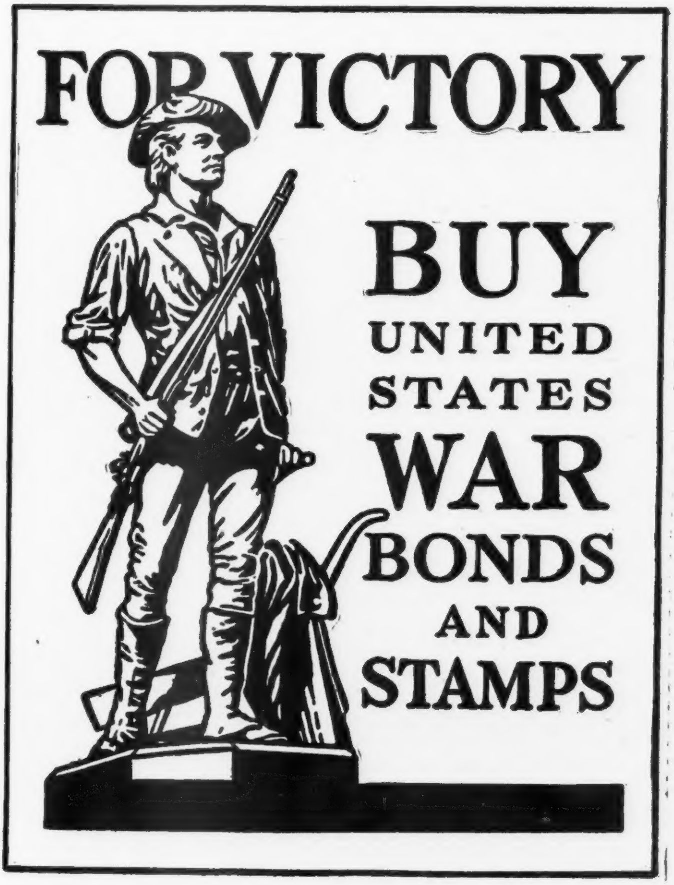
The climate conducive to confidence and cooperation can be materially affected by government regulation. The country has accepted willingly an extreme degree of regulation as necessary to the winning of the war. The law of supply and demand ceased to function, and the Office of Price Administration came into being. The control of competition over profits ceased to work, and we have renegotiation and excess profits taxes. We have given up a great deal of our individual freedom under the selective service law and the regulations of the War Manpower Commission. Regulation is a means to an end, not an end in itself; the end justifies the means under war conditions but war-created regulations should be relaxed or removed as soon as conditions permit.

Some degree of regulation is, of course, necessary in peace times but it should include the minimum possible interference by government with economic laws. Prices should be allowed to find their own level as soon as restrictions can safely be removed after the war. We have tremendous productive capacity and as conditions return to normal, increased production, and the resulting competition for the consumer's dollar, will keep prices down more effectively in the long run than can be done by government.

The scope of regulation should be limited to the purpose to be served and it should not be directed to the accomplishment of other purposes. The purpose of public utility regulation, for example, is to obtain the lowest possible rates that are fair, not the lowest possible rates, or rates which will foster public ownership. Regulation should be enforced in a truly objective manner and in accordance with the policies established by Congress in enacting it. If one law can be stretched beyond its purpose so can another. The manner of enforcement should not be influenced by the personal views of the administrator. Laws should be administered by reasonable men and in a reasonable manner. Such an attitude is necessary in order to maintain confidence in the good faith of government.

In the past we have been inclined to take democracy for granted. More recently the world struggle in which we are engaged has taught us that democracy is a sensitive and living organism, that it must be nurtured and worked for, and if necessary fought for. Events have confirmed our belief that under a democratic form of government nations attain their highest level of accomplishment, whether it be in the standard of living of the people, in their level of culture, in their capacity for production, or in their ability to make

war. Democracy can be wrecked by self-seeking groups, either domestic or international, unless protected by positive action. The struggle to maintain it is worthwhile. We must make democracy work.



The Auditing Process

By Christian Oehler, C.P.A.

THERE are many different types of accounting services, and these are classified into, let us say, five major divisions. A brief survey of these five major divisions at the outset, may enable us to understand the auditing process a little better, because it will afford the opportunity of contrasting auditing with the other four major divisions.

The five major divisions into which accounting services are usually classified are: (1) Construction, (2) Operation, (3) Review, (4) Interpretation and (5) Tax services.

The first of these includes such services as the work of designing accounting systems, which contemplates, among other things, the planning for the routing of the transaction through the organization, planning the transmission of information to those who will make the record, planning the procedure for the act of recording, and designing the forms to be used. Every system of accounts must be custom built, because every business is different from every other business. But, in the building of an accounting system, certain fundamental principles common to all businesses must not be overlooked. For example, in the planning of office routine, it is necessary to provide for first things first; thus, remittances received from customers must be deposited promptly in the bank and credited promptly to the customer's account, even though in the process it becomes necessary to hold up the cash book entry. Another fundamental principle is that provision must be made for the strongest possible internal control available to us under the circumstances—i. e., the strongest internal control that can be provided with the available personnel. Another matter that falls within this division of accounting services is the making of budgets; this includes not only the preparation of the budget itself, but also the provision for the comparison of the budget amounts with the actual amounts and, where the system provides for standard costs, for the comparison of the budget amounts with the standard costs and for the review of the accounts that reflect the variances from the standards. There are many other matters that fall properly within this division of accounting, such as providing for a central planning committee to insure cooperation between various departments—sales, purchases, warehouse, treasurer, etc., and planning for the taking of inventory.

The second major division of accounting services includes all services involving operating the accounting system. This consists in accounting for (1) values and (2) results. By accounting for values is meant a record that will reflect clearly that the persons to whom values have been entrusted have accounted properly for them, e. g.,

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the cashier and the cash handled by him, the treasurer and the various bank accounts and securities subject to his control, the warehouseman and the merchandise or stock in trade. By accounting for results is meant a record that will make available to the proper authorities information with regard to the kind of a job the sales manager is doing, the kind of a job the credit manager is doing, or the purchasing department, or the treasurer, or any other department of the business, or official, or key man. Bookkeeping falls within this division; bookkeeping comprises not only the actual recording of the transactions in the books of account, but also the preparations of financial statements and other reports based upon or taken from accounting data.

The third major division of accounting services includes all services of an auditing nature. Since this is the major topic for discussion tonight, the survey of what it comprises will be postponed until the other two major divisions have been surveyed.

Accounting services involving the interpretation of accounting data comprise the fourth major division. Interpreting the accounts is answering the question "What do the figures mean?" Reading a balance sheet and an income statement falls within this division. The meaning of working capital and the significance of changes therein over a period of time, the meaning of the net ledger value of property, the distinction between the regular, incidental and extraneous profits or losses of a business entity constitute a portion of the subject matter of this division. But the division includes not only the interpretation of the financial statements, but also the interpretation of ledgers, journals, working papers and all other accounting data.

Under present day conditions, tax services constitute an increasingly important part of the accountant's work, and for that reason may very well be said to constitute a fifth major division in the classification of accounting services. There are problems in tax practice which fall entirely within the field of the practice of law and which only the lawyer is competent to handle. There are other problems which fall entirely within the field of the practice of accountancy and which only the trained accountant is competent to handle. Some cases require the services of both the lawyer and the accountant, and in other cases, either the lawyer or the accountant, working without the assistance of the other, can perform a creditable piece of work.

These major divisions of accounting services are not neat little pockets into which this or that accounting engagement may be snugly fitted. In many cases, accounting services overlap two or more of these major divisions. An audit report may and frequently does include interpretation of the financial statements as well as suggestions for the improvement of the internal accounting control, thus extending from the field of review into that of interpretation and construction of accounts. Many a small business entity keeps its books of account solely for the purpose of accumulating data for the preparation of tax returns, and an accountant might be engaged for the purpose of designing a set of books for that particular purpose, thus working in the field of tax service and in the field of construction of accounts.

This brief survey has been made in order that the auditing process may be compared and contrasted with the various other forms of service and that engagements in which other forms of service are contemplated, may be identified and understood.

The auditing process is essentially a process of review, a process of examination of books of account, records, and other accounting data for the purpose of verification. The broad general purpose of the auditing process is the determination that a proper accounting has been made for (1) values and for (2) results and that the finan-

cial statements properly reflect the financial condition and the operating results of the business entity under review.

Accounting for values implies that the treasurer, for example, has accounted for all the cash and securities that have been entrusted to him; that the foreman or plant superintendent has accounted for tools, machines, supplies, materials, etc.; that the warehouseman has accounted for all the merchandise that has been entrusted to him.

The pattern of accounting for values is based upon common sense and is easily understood and remembered. It is simply this: the starting point is the amount to be accounted for at the close of the preceding accounting period; to this is added whatever additional amounts have been entrusted to the individual or department which must make the accounting; the sum of these two is the total to be accounted for during the current accounting period; from this total is then subtracted all amounts which have been properly disposed of during the period and are accounted for by properly approved vouchers; the remainder is the amount that is to be accounted for at the close of the current accounting period and carried forward into the next succeeding accounting period.

Accounting for values at the close of the current accounting period implies accounting at the final date of that period for the existence, ownership, liens and valuation of the assets of the business or other entity which should be accounted for at that date. This means that the auditor must satisfy himself that the assets have actual existence, that the ownership is vested in the accounting entity, that liens, if any, are properly reflected in the books and in the financial statements, and that the valuations placed upon them are in accordance with accepted accounting principles.

Verification of existence may be an easy matter, or it may be a difficult matter, or it may be entirely beyond the ability of the accountant. The verification of diamonds as asset of a jewelry store is beyond the ability of the accountant as an accountant; the substitution of paste for the genuine stones could quite easily be made and quite as easily escape detection.

Verification of ownership is also a matter that is not always easy to accomplish. Cash or currency in the till does not bear any marks of ownership and may actually be the property of someone else, introduced for the purpose of covering a shortage.

If any of the assets are pledged as collateral for loans, or are liened for any purpose, that fact should be disclosed in the financial statements. The importance of this phase of the work of verification cannot be overemphasized.

In the field of the verification of valuations used on the balance sheet, many misunderstandings have arisen, particularly in the minds of those who have had no training in accounting principles. In accounting for the valuation of assets, a clear distinction must be made between value and valuation, and between the engineering concept of valuation and the accounting concept of valuation.

Value is an objective reality; the valuation is subjective and is the opinion of the valuer as to what the value is. Valuation is a measure of value and will differ as between valuers.

If instructed by a court to find the true value of a business entity, I should be obliged to ask for and obtain much more detailed instructions. "What is true value?" is very like the question asked by Pilate "What is truth?", and you will recall that Pilate did not wait for an answer.

Going concern value, liquidating value, forced sale value, scrap value, earning power value—which of these shall we attempt to measure. Which of these is the true value? Under all circumstances? Or, under special circumstances?

Valuation is an engineering problem. The accountant is not a valuer. But the accountant does use valuations, and certifies to financial statements in which valuations are expressed. His use of valuations, however, is based upon accounting conventions because the accounting concept of valuation is itself an accounting convention.

The accounting valuation of machinery and equipment, buildings, furniture and fixtures and other depreciable fixed assets, furnishes an excellent example of the accounting concept of valuation as distinguished from the engineering concept. The general practice is to show these assets at cost less the reserve for depreciation and to build up the latter on the straight line method. Thus, if an asset is expected to have a ten year life, one-tenth of its cost (less perhaps a portion for scrap or salvage value) is charged against operations each year and added to the reserve. At the end of five years, the net ledger value of the asset (i.e., the cost less the accumulated reserve for depreciation) is one-half its cost. If the asset has been properly maintained, this valuation is very probably too low to represent value in use; and it is equally probable that it is too high to represent sales value. The net ledger value means only the portion of the cost that has not yet been charged against earnings.

If the accounting conventions have not been observed that fact will be disclosed on the face of the balance sheet, as for example, when an appraisal of the property has been made by engineers and the result of the appraisal is reflected in the financial statement.

Accounting for results implies that the transactions have been recorded in such a way that the records will disclose what transactions have taken place, whether they were authorized, and whether there was any dereliction of duty in the performance as far as that may be determined from a review of the accounts. Verification consists in determining that the transaction actually took place, that it was properly approved, that it was properly recorded and that the persons handling the transaction and those recording it had authority to act. At least, it is hoped that the auditing process will verify that these things are true; but there are certain limitations, some of them imposed by the very nature of things, others by the condition of the accounting records and by the scope of the engagement.

The purposes which may underly the engagement of auditing services are many, and if misunderstandings are to be avoided, the purpose for which the auditor is engaged should be disclosed to him by the client. If the client does not volunteer the information, the auditor should ascertain the purpose by direct inquiry. Because the purposes for which the services may be engaged are very numerous and because the accountant is not a mind reader, it is of the greatest importance, if audit work is being engaged for a specific purpose, that the purpose be ascertained and explained before the work is undertaken.

Usually the purposes underlying the engagement of auditing services are classified into two general groups, viz. (1) internal purposes and (2) external purposes.

Internal purposes are numerous and may be general in their nature or they may be specific. The management may desire to ascertain from independent sources that the financial prepared by the company's own accounting department are reliable and fairly present the financial condition and the operating results. The purpose may be to determine whether the accounting system provides the proper safe-

guards against serious error, whether honest or fraudulent, or that the office routine is economical and that the personnel is efficient. Frequently the purpose is the very general one of ascertaining whether the company's own accounting department is functioning properly.

External purposes include such purposes as the verification that the net assets and the net income are not over-stated in financial statements that are to be used for credit purposes or for investment purposes.

It should be recognized that a discussion of purpose is of the greatest importance before any auditing work is actually started.

The scope of auditing services, unlike the purpose (or purposes) for engaging auditing services, is not a matter for discussion with the client. It is a matter of professional judgment and skill and should be left entirely in the hands of the auditor. The auditor will prescribe the form and scope of service, just as the physician will prescribe for his patient.

Auditing services are usually classified according to scope of service into (1) audits and (2) examinations. There is no sharp line between the two. Auditing services cannot be divided and subdivided into neat categories. Sometimes it is hard to say of a given engagement whether it is an audit or an examination as it may partake of the nature of both. Generally speaking, the scope of an audit is such that the various internal purposes may be satisfied with respect to the financial statements, the accounting system, the office routine and personnel; the examination, on the other hand, usually contemplates nothing more than the verification that the net assets and the net income are not overstated.

Occasionally a client, or prospective client, may ask an auditor to make a cash audit. This request is made because it is thought that it may be less expensive to have only the cash audited than to have all the items in the balance sheet and income statement audited. Really the cash audit is a complete audit (except for depreciation, depletion and similar items) for the reason that the cash receipts cannot be verified without the verification of the sales and the accounts receivable or other sources from which the cash may come; and the payments cannot be verified without the verification of the purchases of materials, merchandise, services, and the like. Verification of the recorded cash receipts is one thing; verification that all receipts have been recorded is quite another. Verification of the fact of payment is one thing, and the verification of the propriety of the payment is something else.

The following broad general outline may serve to illustrate some of the differences in auditing services as well as the general pattern of four different types of service:

Item for verification	**Scope of verification**			
	I.	II.	III.	IV.
Cash transactions	100%	Test	Test	Test
Recorded assets	100%	100%	100%	100%
Unrecorded assets	100%	100%	None	None
Recorded liabilities	100%	100%	100%	100%
Unrecorded liabilities	100%	100%	100%	100%
Operations	100%	Test	Review	None
Unrecorded charges	100%	100%	100%	None
Unrecorded income	100%	100%	None	None
Review of accounting system	100%	Test	None	None

Item for verification	Scope of verification I.	II.	III.	IV
Review of office routine	100%	Test	None	None
Review of personnel	100%	Test	None	None
Survey of internal control	100%	100%	100%	100%

I. Complete audit.
II. Test audit.
III. Examination accompanied by a review of the operations.
IV. Examination of financial condition without review of operations.

The above general outline should not be interpreted as a rigid classification of auditing services, because such a classification is not possible; it is nothing but a representation of the broad general scope of certain types of service, showing the pattern which they usually follow subject to additions and variations.

Limitations of auditing services fall into three broad classes; (1) those imposed by the nature of auditing; (2) those imposed by circumstances and by conditions that may be outside or beyond the control of the client; and (3) those that are imposed by the client.

Limitations imposed by the nature of auditing are generally such that they may be readily removed by the performance of the necessary preliminary accounting work. The auditor must not be expected to keep the books; that form of service belongs in the class of operating the accounts and not in the class of reviewing them. This does not mean that the auditor should not write up the books; accountants are frequently engaged to do just that, but it is not auditing service. Monthly write-up work is not at all infrequent among the smaller firms and individual practitioners. But an auditing engagement as such does not contemplate the performance of work that should be performed by the client's own accounting department.

Moreover, the auditor cannot be expected to make an audit or examination if the books are poorly kept, or incomplete, or out of balance. This is another limitation imposed by the nature of auditing; it can be removed by the completion of the necessary preliminary accounting work. Bringing books into balance is not auditing service; it should be done by the client's own staff, perhaps under the guidance of the public accountant, if in the judgment of the latter, it is necessary. But even if it should be considered necessary, it is bookkeeping and accounting work and not auditing. The auditor would be expected to point out that the books are poorly kept, or incomplete, and make his recommendations as to how the situation can best be remedied at the least expense to the client. Of course, the auditor may undertake to perform the necessary bookkeeping and clerical work before undertaking his audit, but it should be understood that there are really two engagements involved here, an accounting engagement and an auditing engagement.

The auditor cannot be expected to spend a considerable amount of time in locating differences and adjusting them. He should be expected to point that differences exist, but the client's own staff should do all the necessary detail work.

The cost of ignoring limitations imposed by the nature of auditing may prove to be very great. The detail work of keeping the books, of locating errors and of adjusting them, and of keeping them free of error as far as that is humanly possible, can be done by the client's own staff for much less money than it can be done by the public accountant. The wise client does not expect

the public accountant to do work that can be done by his own staff; he uses the services of the public accountant to much better advantage. The wise public accountant, in like manner, does not perform work that can be done by his client's own staff at less expense; but rather will he assist in the training of the client's staff so that his own work will be reduced to a minimum. Where this procedure is followed, the client receives much better service and the auditor receives much better fees. The public accountant has nothing to sell but his time; its value to his client depends not only on the skill of the accountant, but upon cooperation between the accountant and his client.

Some limitations of auditing services are imposed by circumstances and by conditions that may be beyond the control of the client. Where the records have been destroyed or where they are found to be wholly unreliable, it may be impossible to make an audit or examination. If currency is spent (perhaps for legitimate business expenses) and no record is kept, it may be impossible to tell what the money was spent for, or to reconstruct the record. The same might be said of sales where, for example, copies of the sales invoices are kept only until the amounts called for are collected and then destroyed and no sales book maintained.

Another limitation imposed by circumstances is that imposed by location, as for example, a small cash fund located at a point where the auditor does not have an office or a correspondent may cost more to verify than the entire amount of the fund. Even if the auditor does have representation at the point, it may be that the cost of verification could not be justified because the effect of overstatement of the amount on the balance sheet or income statement would be negligible, and the failure to verify would not therefore violate the principle of full and complete disclosure, if it were not mentioned in the report.

Sometimes limitations are imposed by the client. This practice is not as frequent as it formerly was, but it is very dangerous to the one who imposes the limitations. It is very much like going to a physician for a physical examination and then asking him not to examine your heart. The accountant cannot be held responsible if something goes wrong because of something omitted from the procedure under the client's instructions. If the error or defalcation is concealed where the auditor cannot find it because of limitations imposed by the client upon the scope of his work, he is clearly not to be held responsible—unless we elect to hold him responsible for accepting that type of engagement. There is a growing sense of responsibility among accountants and more and more they are refusing such engagements, because even though they are clearly not to blame when something goes wrong, some of the odium attaches to them.

The accountant should inform his client that he must proceed only in accordance with methods which he, the accountant, deems appropriate, or that he must otherwise withdraw from the engagement. If the client wishes the work performed according to his own detailed instructions, then he should add the necessary personnel to his own staff for the purpose.

In determining the scope of his services, the auditor relies to a very large degree upon the internal control in effect in his client's office. Internal control comprises all those devices of internal organization whereby assets are safeguarded and the records kept reasonably free of error by having one employee act as a check upon another. If the man who handles the cash is not per-

mitted to have access to the customers' records, then the work of the cashier exercises internal control over the work of the customers' ledger bookkeeper in recording credits to the customers' accounts; and this work, in turn, serves as internal control over the work of the cashier in recording and depositing collections received from customers. If the payroll is prepared by the accounting department and distributed by the paymaster's department, internal control is brought about by each department acting as a check on the other. Two employees who are independent of each other should have joint control over securities, if effective internal control is to be provided. The same is true of counter-signatures on checks; if a treasurer and his assistant sign, there is no internal control, because the two are not independent; but if a representative from the treasurer's department and a representative from the comptroller's department, there is effective internal control because the two officers or employees are independent each of the other.

Vacations constitute a means of internal control, because the work of the one who is going on vacation is turned over to someone else to perform in his absence. The auditor should always beware of the clerk who never takes a vacation—perhaps he doesn't dare leave his work because of fear of what may be disclosed. Rotation of clerks within the office is also a device of internal control which is frequently adopted.

Some of the larger business entities have very elaborate systems of internal control, but because of the large number of employees required, these elaborate systems are not available to the smaller business entity. Limitations upon the nature and effectiveness of the internal control are imposed by lack of personnel where the business entity is small; but most of these businesses can and should make use of the minimum requirements, some of which have been mentioned above.

The effect of internal control on the reliability of the accounting data should be apparent at this point. If the internal control is strong and effective, there is little likelihood of anything being seriously wrong with the records.

In thinking of this particular point, however, it should be borne in mind that it is much easier to alter a balance sheet or an income statement than it is to alter the underlying detail. It is for this reason, among others, that the agreement between the financial statements and the books of account is so important. Insistence upon agreement with the books, however, even though it is a point well taken, is not the final word; if there should be agreement, it must be realized that the books must be reliable or the statements that are in agreement with them cannot be.

A good internal control on paper is not necessarily effective. The employees may have taken shortcuts that have destroyed its effectiveness. Employees may do this to save time or to save themselves work, but if the pattern of the internal control is not being followed, it may be worse than useless—because the management will be relying upon something that is not there to be relied upon.

The effect of internal control upon the scope of services determined upon is this; the stronger the internal control, the less work need be done, the fewer samples may be selected; the weaker the control, the greater the number of samples that must be selected. In the selection of the samples for verification, the choice will be made with regard to specific phases of the client's accounting system and with due regard, not for the internal control as

a whole, but with regard to the internal control in the specific job or specific record. But however strong the internal control may appear to be, the auditing process cannot be dispensed with. Those officers and directors of banks and of industrial enterprises and, in fact, of any other business entity, who are relying upon their internal control without review by independent public accountants are being penny wise (if they are trying to save an audit fee) and pound foolish. Some day something may go wrong and upon investigation it will be found that the internal control which was so carefully planned was not being carried out in practice.

Where the internal control is found to be effective after a survey has been made, the auditing process consists of testing the accuracy and reliability of the accounting data. This is the theory of sampling applied to the auditing process. The sample selected must be adequate, that is, it must be sufficiently large to give us a fair picture in miniature of the whole. The sample must be representative, that is, it must cover the entire field of study, not only the sales, but the purchases, the cash receipts, the cash disbursements, and so on, through every type of transaction. The sample must be selected without foreknowledge of the client or the client's employees; the element of surprise may be exceedingly important, particularly in the verification of cash and of negotiable securties. The sample to be selected will consist of entries in books of account, of papers, documents, contracts, invoices, etc., supporting the entries in the books. Vouchers are documents attesting to the authenticity of transactions. Cancelled checks are vouchers attesting to the fact of payment, but not to the propriety of payment; invoices, bills, and statements are needed for this.

There are other facts affecting the scope of service in addition to the internal control. The first of these is the nature of the business. In a trading concern, the working capital position and the inventories in particular, are of the greatest importance and merit the greatest amount of consideration in the amount of time and effort to be spent in their verification; in railroads, public utilities, the property accounts, maintenance and depreciation, deserve a great deal of attention; in Wall Street houses, the accounting for securities is of prime importance.

Another factor is the calibre of the personnel. The careful clerk requires less attention than the careless one; the well-trained and capable clerk requires less attention than the one who is less well-trained and less capable. The manner in which the work is laid out in the office is always an important point for consideration: where the duties are not clearly designated, more attention is required than in cases where each individual in the office has specific duties to perform, knows what they are, and knows how to perform them The department or person who is pressed for time or lack of help requires more attention than the one that is not so pressed; pressure leads to errors. And finally the morale of the client's staff must not be overlooked. The happy employee is the one that turns in the best day's work. Happy employees are likely to be honest employees. The employee who thinks that his employer is taking advantage of him is the more likely to attempt to steal, or at the very least, to "lay down on the job".

At the conclusion of an auditing engagement, it is customary for the auditor to submit an audit report. An audit report (and, by the way, the audit report should never be referred to as the "audit") in the strictest sense consists only of a cer-

tificate and the financial statements which are certified.

The certificate is the opinion of the auditor that the financial statements fairly present the financial condition and operating results of the business entity, subject perhaps to qualifications. The certificate always contains two parts, the preliminary statement covering briefly the fact of audit and second, the opinion paragraph which states that the statements fairly reflect the financial condition and operating results. In addition to these, there may be qualification paragraphs or explanatory paragraphs, when in the opinion of the auditor they are necessary.

The financial statements consist of (1) the balance sheet, (2) the income statement, and (3) the reconcilement of surplus. The latter is a statement which explains in summary form all the changes in surplus since the date of the most recent closing of the books.

It is customary with many accountants to go into the field of interpretation in the report; and in these cases, the report may contain comments on the financial condition, the working capital position together with an analysis of the changes in the working capital, the operations, the condition of the receivables, and many other matters.

It is not so important for the auditor to tell what he did, but it is very important for him to tell what he did not do, e.g., where he may have omitted some part of standard auditing procedure, such as attendance at inventory taking, confirmation of receivables and payables, reconcilement of bank balances or other verification procedures.

It was not the intention to cover completely the subject of the auditing process, as obviously a subject of such wide scope could not be covered in one evening, or even in several evenings. The intention was to present some of the high lights and to assist you to a little better understanding of just what the auditing process is. It is hoped that this purpose has been achieved.

Relation of Accounting Principles to the Solution of Federal Income Tax Problems

By DR. JOSEPH J. KLEIN, C.P.A.

I—PRELIMINARY OBSERVATIONS

AS you will note from the mimeographed outlines which have been distributed, I intend to discuss with you a number of cases, some of them recently decided, which will illustrate the application of accounting principles in the determination of taxable net income. The number of cases which will be analyzed and discussed will depend on the time required to present a number of essential preliminary topics. Aside from some introductory observations, these preliminary topics include discussion of "accounting principles," "income" both as an accounting and as a federal income tax concept, and deliberate legislative deviations from sound accounting practices in the determination of taxable income.

(1) Basic problem: "Accounting income" versus "tax income."

Fundamentally, every income tax problem involves, aside from Constitutional and procedural questions, an amount of tax—payment or refund thereof. In the determination of the federal tax on incomes—and we are not dealing tonight with any other phases of taxation—the amount subject to tax is frequently found through the help of bookkeeping or accounting. This is surely true of the income of business enterprises. As we shall soon see, "taxable income" and "accounting income" are by no means identical. Nevertheless, Congress must have intended that accounting principles, to a much greater extent than is actually the case, should govern the determination of taxable income.

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(2) Interaction between accounting principles and income tax decisions.

Manifestly, tax law has influenced accounting principles, but as accounting does not function in a vacuum, it has been influenced by other factors as well, among which are law in general, business management, credit seeking, and requirements and mandates of governmental agencies. See, for example, *Sources of Accounting Principles,* by Professor Roy B. Kester, in the Journal of Accountancy for December, 1942. But just as accounting does not function in a vacuum, neither does it travel a one-way street. It influences taxation. Roswell Magill, in his *Taxable Income,* points out that "there is likely to be a gradual cross-fertilization between the in-

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come tax decisions and accounting principles, as each group of specialists comes to know the other's theories and results."[1]

(3) Inevitable effect of high income tax rates.

The pressure of income tax accounting on business operations is indisputable; the effects of the pressure are manifest in many ways, directly and indirectly, including the form selected in which to conduct business. The activities and operations of a business are undeniably influenced by net results,—profits *after* taxes. In the presence of a federal taxing statute with rates at almost a confiscatory level, which claims 95% of corporate net income (with a post-war refund provision of 10% thereof) and as much as 94% of noncorporate net income, no wonder that accounting for taxable income has come to be recognized as of primary significance. It is to be expected that honest taxpayers will seek accounting practices which result in avoidance of unnecessary exposure to taxation, and in postponement of such exposure as long as possible. When tax accounting deviates from financial accounting, it becomes of the utmost importance that such deviations be absolutely justified under the Constitution and in the statutes. Resistance is natural to any tax administrator's interpretation which seeks unjustifiably to increase taxable income or attempts too early precipitation of tax liability.

(4) Static definition of "income" not to be expected.

Neither the concept of accounting income nor that of tax income is static; as accounting principles and practices develop, the concept of accounting income is modified and changed; with each amendment of the Internal Revenue Code the statutory definition of tax income changes.

Under the Constitution, the term "income" will not be put in a straitjacket by a definition which will for all time confine it to a fixed connotation. The courts will, from time to time, in dealing with specific cases, give earlier definitions greater preciseness, expand where necessary or expedient, but no static definition is to be expected.

(5) British vs. American philosophy of tax administration.

The British income tax administrator has a degree of discretion vested in him that the American legislator appears to regard as practically unthinkable. That is why the British income and excess profits tax statutes are so short, while our taxing laws are so long, detailed and complicated, and, perhaps, why they are so frequently amended. The British tax administrator is intended to administer the law in a *quasi*-judicial spirit; the American counterpart is expected to be "Treasury" minded. Rare, indeed, is the official who seeks justice only and who really does not care "where the chips fly." Fortunately, there are some such officials in key positions in the Revenue Bureau, both in Washington and in the field. An Attorney General has advised the Treasury that revenue laws should be interpreted so as to favor the revenue.[2] An opinion of a later Attorney General is more consonant with the rule that reasonable doubts as to taxable income are to be resolved in favor of taxpayers.[3] Many

[1] Rev. ed. (1945), p. 20.
[2] 18 Op. A. G. 246.
[3] T. D. 3754 (IV-2 C. B. 37).

field agents act as though they had been brought up on 18 Op. A.G. 246; fortunately, fewer higher Bureau officials are uninfluenced by *Gould* v. *Gould*,[4] *Smietanka* v. *First Trust & Savings Bank*[5] and *U. S.* v. *Merriam*.[6]

II—ACCOUNTING PRINCIPLES

In the determination of business income, it is recognized that important as is the application of sound and accepted accounting principles to the elements and factors with which the accountant deals, it is of at least equal importance that such principles should be consistently applied. Such two-fold criterion is embodied in the certified public accountant's report or certificate based on his audit or examination:

> "In our opinion, the accompanying balance sheet and related statements of income and surplus fairly present the position of Company at , 1944, and the results of its operations for the year then ended, *in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.*" (Italics supplied for emphasis)

As Mr. George O. May, in his lecture on "Distribution of Profits," or Mr. Carman G. Blough, in his talk on "Effects of S. E. C. and Treasury Department Policies on Application of Accounting Principles" may have told you, an "accounting principle" is neither the philosopher's "fundamental truth" nor the mathematician's "axiom." An accounting principle is really a "convention" or a "rule" derived empirically. Thus:

> ". . . Initially, accounting rules are mere postulates derived from experience and reason. Only after they have proved useful, and become generally accepted, do they become principles of accounting. But in discussion the word is often invested with an aura of sanctity, arising out of its more fundamental meanings, thus leading many to attribute to the rules of conduct called principles a greater force and a more universal and permanent validity than most of them were ever intended to have."[7]

In this presence, it may be most helpful to liken an accounting principle to a principle of law which stems out of decisions of the courts. But such court decisions frequently present conflicting principles. It then becomes your job and mine to try to find the principle which applies most aptly to the specific facts of a particular case. In a similar sense, we speak of an accounting principle—no more, no less sacrosanct, fixed, immutable, than a principle of law. In both fields the principle is helpful for it satisfies practical needs.

As a single illustration of a firmly established accounting principle, I offer the well established practice or rule:

> The revenue of a given accounting period shall be charged with, and offset by, all costs and expenses fairly attributable or applicable to such revenue.

I shall not add another illustration, but I do refer you to the distinction between income and capital, recognized both by the accountant and the economist. The accountant's recognition of the distinction finds expression in a principle or rule or practice.

[4] 245 U. S. 151 (1917).
[5] 257 U. S. 602 (1922).
[6] 263 U. S. 179 (1923).
[7] Report of Committee on Terminology, Amer. Inst. Accts, Accounting Research Bul. No. 7.

"Approved standard methods of accounting," the expression in the Treasury Regulation,[8] is quite synonymous with "generally accepted accounting principles," the statement in the independent accountant's report or certificate and with "good accounting practice."

III—APPLICATION OF GOOD ACCOUNTING PRACTICE TO INCOME TAX PROBLEMS

The essential task of accounting, in its relation to the solution of the type of income tax problem with which we are dealing, is to aid in determining the *quantum* of income and the taxable period to which it belongs. The problem itself involves differentiation between "accounting income" and "federal income tax income." Aside from those distinctions which are statutory,—and we shall refer to such differences shortly,—I should, in passing, remind you that income is determined by the facts and not by mere bookkeeping entries.[9] This is as it should be.

My good friend, Judge J. Gilmer Korner, Jr., while Chairman of the United States Board of Tax Appeals, embraced the opportunity to philosophize about accounting.[10] What he wrote makes interesting and pleasant reading, but it is probably undeservedly complimentary.

IV—"INCOME" AS AN ACCOUNTING CONCEPT

When an accountant speaks of "income" he has in mind "net income," or, at least, he frequently employs the terms synonymously. So do the business man and the economist.[11] Quite frequently, the accountant uses interchangeably "income" and net "earnings and profits."[12]

Robert H. Montgomery has suggested an acceptable definition of net income:[13]

> "The net income of a business is the remainder of the earnings and profits from all sources after providing for all costs, expenses and allowances for accrued or probable losses."

In 1941, the Committee on Terminology of the American Institute of Accountants reported that the definition of income in *Eisner* v. *Macomber*[14] "conformed closely to the accounting concept, and is, therefore, appropriate for adoption by accountants for general use as well as for tax purposes":[15]

> "Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets . . ."

It has often been observed that the accountant's concept of income is a conservative one, and that it discloses the influence of credit grantors who had learned, through sad experience, that anticipated profits frequently were not realized while the possibility of future losses was often regarded too optimistical-

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[8] Reg. 111, Sec. 29.41-2.
[9] *Doyle* v. *Mitchell Bros.*, 247 U. S. 179 (1918).
[10] *Goodell-Pratt Co.*, 3 BTA 30 (1925).
[11] Seligman, *The Income Tax*, (1914), p. 19.
[12] The expression "earnings and profits" has a special statutory meaning. See Reg. 111, Secs. 29.115-11 to 29.115-14.
[13] *Auditing Theory and Practice*, Sixth Ed., p. 421.
[14] 252 U. S. 189 (1920).
[15] Accounting Research Bulletins, No. 9 (Special).

ly. Hence the injunction: anticipate no future profits, but show possible future loss.

Because income is measured in money, and because in modern business the calculation of the *amount* of income for a year involves many transactions recorded through the bookkeeping process which, at least to many lawyers, appears not only mysterious but *mathematical,* an "aura of sanctity" has frequently been impressed—especially by attorneys—on the end results shown in the balance sheet and in the income statement. In sober truth, much of the conclusions expressed in such financial statements is based on estimate. This is inescapable, because these statements merely express the *opinion* of management as to values, overlapping income, expenses in incompleted transactions, etc. And when the certified public accountant reports on such statements, as a result of his audit, he likewise expresses his opinion on the opinion of management, which alone is responsible for the substantial correctness of the representations implicit in such statements.

Accountants recognize two fundamental bases for determining net income of a period: the cash receipts and disbursements basis, and the accrual basis—itself really a number of different bases. The first basis is of very limited application; the latter is necessary for most trading and all manufacturing enterprises. The regulations recognize these bases, although, at least until quite recently, some officials appeared to regard the accrual basis as *one* distinct method. In reality, there is *the* cash basis, approved for those not in business and, to a very limited extent, for some others; and then there is the approved accounting method or procedure of business organizations which, while they must employ *an* accrual basis in order to determine (approximately) correct income, cannot have their accounting procedure identified with sufficient definiteness by saying that they are on *the* accrual basis, and nothing more. The accrual basis, when used by traders and manufacturers, involves the use of inventories. Inventories require determination of quantity and value. Certain types of business have developed special inventorying methods and procedures, and these constitute recognized accounting practices. The law[16] and the regulations[17] recognize and approve such established practices.

Where the statute refers to the taxpayer's "method of accounting," Congress undoubtedly had in mind methods of accounting in accordance with recognized professional practices grounded in approved accounting principles.[18]

Taxpayers must use either the cash basis *or* an accrual basis. Taxable income, in general, is not to be calculated on a hybrid basis.

Mr. Justice Stone, in the *Anderson* case (joined with *U. S.* v. *Yale & Towne Mfg. Co.*),[19] pointing out that the Revenue Act of 1916 must have contemplated the accrual method of accounting and that the true income for the year "could not have been determined without deducting from its gross income . . . the total cost and expenses attributable to the production of that income," stated:

> "It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging

[16] I. R. C. Sec. 22(c).
[17] Reg. 111, Secs. 29.22(c)-1 to (c)-8.
[18] I. R. C. Secs. 41, 42, 43.
[19] 269 U. S. 422 (1926). But see later contra holding in *Lucas* v. *American Code Co., Inc.*, 280 U. S. 445 (1930).

against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period."

Here is Clear Recognition of the Accrual Basis of Accounting.

In the *Anderson* case, the issue involved the deductibility of the munitions tax which was based on the business of 1916, but not paid until 1917. It was not until the latter year that the amount of the tax was known or paid. In effect, a reserve for the tax was allowed in the computation of the taxable income for the year 1916. The *time* of the deduction was found to be 1916, to which the deduction applied and in which year the revenues were reported, and not the later year of payment.

While we are now dealing with the accountant's concept of income, a very brief word regarding the economist's concept is in order. Economists quite universally define "income" as, in effect, the succession of pleasurable sensations imparted to us by things or services. They regard wealth as the fund or stock of such goods.

For practical purposes, we must use a yardstick — money — to evaluate such satisfactions, *i.e.,* income, "Money income" refers to the time of receipt (or its equivalent on an accrual basis), rather than to time when the money is spent for psychic pleasures or satisfactions. Hence, Haig's often-quoted definition:[20]

> "Income is the money value of the net accretion to economic power between two points of time."

Seligman would add to Haig's definition:[21]

> " 'Separation,' that is, a separation of the accretion from the fund by 'realization.' "

Upon analysis, Haig's and Seligman's definition are not radically different from the one sponsored by accountants.

V—"INCOME" AS A (FEDERAL INCOME) TAX CONCEPT

In the very nature of things, accounting principles and practices will influence determination of taxable income through tax legislation, through tax administration and through judicial interpretation *but the statute remains supreme.* Accounting principles, when persuasive (with notable exceptions), guide the courts; when so-called principles are arbitrary or illogical, and especially when not generally accepted, they are ignored by the courts.

Taxable net income is what the statute says it is. But the statute vacillates and changes altogether too frequently. And at any moment of time there are a number of different statutory "net incomes." Thus, this very evening, the Internal Revenue Code (as amended to date), defines "net income" in a number of different ways. I shall mention a few of them:

(a) Normal tax net income (for corporate and other taxpayers) —see Sec. 21(a)

(b) Surtax net income (for corporate and other taxpayers)—see Sec. 12(a)

(c) Declared value excess-profits tax net income (for corporations)—see Sec. 602

(d) Excess profits net income (for corporations) (i) on earnings basis—see Sec. 171(a)(1); (ii) on invested capital basis —see Sec. 711(a)(2)

I have had occasion to refer to the

[20] *The Federal Income Tax* (Col. U. Lectures, 1920), p. 27.
[21] *Are Stock Dividends Income?* (American Economic Review, Sept., 1919).

fact that "income" and "earnings and profits" are different concepts. Dividends, as per statutory definition, are distributions out of "earnings and profits"[22] rather than out of "income." The former, when reduced to "net," is much more akin to the accountant's net income.

In *Com'r* v. *Wheeler,—U. S.—* (March 26, 1945), the Court stated:

> "But 'earnings and profits' in the tax sense, although it does not correspond exactly to taxable income, does not necessarily follow corporate accounting concepts, either. Congress has determined that in certain types of transaction the economic changes are not definitive enough to be given tax consequences, and has clearly provided that gains and losses on such transactions shall not be recognized for income-tax liability but shall be taken account of later. §§ 112, 113. It is sensible to carry through the theory in determining the tax effect of such transactions on earnings and profits."

The courts regard "income," undefined in the Sixteenth Amendment, according to the layman's conception of the term, rather than that of accountant, economist or lawyer. Its meaning is "not to be found in its bare etymological derivation. Its meaning is rather to be gathered from the implicit assumptions of its use in common speech."[23]

It is appropriate to conclude our discussion of the federal income tax concept of income, by referring to three Supreme Court decisions.[24]

As early as 1913, the Court defined income "as the gain derived from capital, from labor, or from both combined."[25] About five years later, the same Court extended the definition so as to include the profit gained through a sale or conversion of capital assets.[26] Finally, in 1920, the Court[27] found "little to add to the succinct definition adopted" in the two earlier cases, but it did emphasize "separation"—Seligman's contribution:

> " '*Derived — from — capital*'; 'the *gain—derived—from—capital*', etc. Here we have the essential matter; *not* a gain *accuring* to capital; not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value, *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in,* being '*derived*'—that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal —*that* is income derived from property. Nothing else answers the description.
>
> "The same fundamental conception is clearly set forth in the Sixteenth Amendment—'incomes, *from* whatever *source derived*' . . ."

VI. THE INTERNAL REVENUE CODE RECOGNIZES THE PLACE AND FUNCTION OF ACCOUNTING IN THE DETERMINATION OF TAXABLE INCOME.

The real forerunner of the present series of federal income tax statutes was the corporation excise tax act of 1909.[28] Its language contemplated

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[22] See Sec. 115(a), (b), (e), (h), (l) and (m); Reg. 111, Secs. 29.115-3, 29.115(12)-29.115(14).

[23] Judge Learned Hand in *U. S.* v. *Oregon-Washington R. & Nav. Co.,* 251 Fed. 211 (C.C.A. 2, 1918).

[24] Klein, Federal Income Taxation, pp. 49-51.

[25] *Stratton's Independence, Ltd.* v. *Howbert,* 231 U. S. 399, 415 (1913).

[26] *Doyle* v. *Mitchell Bros. Co.,* 247 U. S. 179, 183, 185 (1918).

[27] *Eisner* v. *Macomber,* 252 U. S. 189, 207.

[28] Act of Aug. 5, 1901 (36 Stat. L. 13-8, C. 6).

the determination of net income on the basis of cash receipts and disbursements. This was found to be impracticable and, consequently, in the administration of the Act, established accounting practices were recognized. By January 8, 1917, such recognition was formal.[29]

We have no need, and there is no time, to trace the evolution of the present Code provisions relating to computation of net income and recognition of sound accounting methods in such determination. Sec. 41 of the Code approves the taxpayer's method of accounting if it clearly reflects income:

> "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income . . ."

Sec. 42(a) of the Code recognizes that receipts of a given year may represent income of another year:

> "General Rule.—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period . . ."

Sec. 43 of the Code relates to deductions and parallels Sec. 42(a):

> ". . . deductions . . . shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred', dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions . . . should be taken as of a different period . . . "[30]

The Code contains other instances of recognition of accounting practices. Thus, in Sec. 22(c), dealing with inventories, it is provided that in businesses where the use of inventories is necessary to determine income, the Commissioner may prescribe the basis for the taking of the inventory

> "conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The regulations of the Commissioner interpreting the Code are quite in accord with the sections from which I have quoted. Thus, Sec. 29.41-3 of Reg. 111 provides:

> "Methods of Accounting.—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so."

Again, Sec. 29.41-2 of the same regulations recognizes standard meth-

[29] T.D. 2433. See George O. May, "Taxable Income and Accounting Bases for Determining It." 40 Journal Accountancy 248 (1925).

[30] This section, in dealing with decedents, refers—I recall no other place in the statute—to "the accrual method of accounting."

ods of accounting and the need of consistency in the application of accounting principles:

"Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency."

The statute provides protection for the revenue where there is manipulation of income[31] or where there are corporate acquisitions primarily for the purpose of evading or avoiding tax.[32]

VII. CONGRESS HAS DELIBERATELY DEPARTED FROM THE CONCEPT OF "ACCOUNTING INCOME" IN ENACTING SPECIFIC PROVISIONS FOR INCLUSIONS, EXCLUSIONS AND DEDUCTIONS.

A person otherwise unfamiliar with the Internal Revenue Code would be justified in assuming, as a result of reading the sections of the law and regulations quoted in the immediately preceding division of this lecture, that taxable net income would be determined in accordance with approved accounting methods consistently applied. The conclusion would be true but for the fact that Congress has seen fit, from time to time, to provide what might be called "exceptions" to sound accounting practice. Some of these exceptions favor taxpayers, others favor the Treasury, and still others favor the taxpayer or the Treasury, depending on circumstances and subsequent events.

These "exceptions" limit the generality of the application of accounting principles to the solution of federal income tax problems. This is so because, regardless of sound accounting practice, the mandate of the statute governs.

We have no time to analyze the various exceptions, ascertain the motivation which induced their enactment, or pass critical judgment on them. It must suffice, in passing, merely to mention some of these exceptions.

Among those which now come to mind, as intended to favor taxpayers, are certain earnings for personal services rendered outside of the United States[33], which are not subject to tax. Then there is partially exempt income in the form of ordinary dividends received by a corporation, only 15% of which is subject to income tax[34] (and none to the excess-profits tax)[34a]. Then, recently, those in the military services have been favored by exemption of the first $1,500 of income from such services[35]. There is, also, the exemption from income tax of the proceeds of insurance payable at death[36], as well as the exemption of sickness and accident insurance and compensation for injuries[37]. Another recent exemption, in the form of a special deduction, is the allowance of "extraordinary" medical expen-

[31] See Sec. 45 of the Code and Sec. 29.45-1(c) of Regulations 111.

[32] See Sec. 129 of the Code (amendment added by Sec. 128(a) of the 1943 Act).

[33] Sec. 116(a). Interest from state and municipal obligations (Sec. 22 (b)(4)) and distributions out of capital (Secs. 115(b) and (d)) are exempt on Constitutional grounds.

[34] Sec. 26(b).

[34a] Sec. 711(a) (1) (F).

[35] Secs. 22(b) (13) and (14).

[36] Secs. 22(b) (1), (5).

[37] Sec. 22(b) (5).

ses[38]. I suppose I should mention, in the present connection, the exemption from liability for tax of the lessor because of improvements made on his property by the lessee[39]. Not so long ago the value of such improvements was income to the lessor. The statute now provides that, under certain circumstances, discharge of indebtedness does not result in taxable income to the favored debtor[40]. Quite recently Congress amended the Code so as to provide for exemption from income tax of bad debt recoveries, prior taxes and so-called "delinquency amounts" to the extent that there had been no prior tax benefit[41]. I suppose that it is proper to include among statutory deviations from accounting principles and practices, favorable to the taxpayer, the carry-back and carry-forward provisions of the statute, which apply both to net operating losses[42] and to unused excess profits credits[43]. Exceptions to the general rule that depreciation, obsolescence and depletion, based on cost, may be deducted from gross income is found in connection with oil, mining and other extractive industries with respect to which specially favorable deductions are allowed on the basis of "discovery value"[44]. Finally, I refer to the provision that only 50% of net long-term capital gains are to be treated as gross income[45]. There is a somewhat similar provision with respect to sales of oil or gas properties[46].

However, as I have already indicated, all statutory deviations from approved accounting practices are not intended to favor the taxpayer; some are meant to favor the Treasury. Thus, on public policy grounds, there are provisions which disallow deductions for net gambling losses,[47] and where wage stabilization and OPA ceiling violations exist.[48] Then, there are the provisions limiting deductions as in the case of long-term capital losses[49] and charitable contributions[50]. While losses resulting from "wash sales", from the point of view of business or financial accounting, are as fully deductible as any other losses, they are not allowed as deductions for income tax purposes[51]. This is likewise true of income, excess profits and certain other taxes[52], and expenses in connection with certain nontaxable transactions[53]. Beside the "wash sale" provision, to which I have already referred, the Code disallows deductions of losses resulting from transactions between certain members

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[38] Sec. 23(x).
[39] Sec. 22(b) (11).
[40] Secs. 22(b) 9 and 10; see, also, *Amer. Dental Co.* v. *Helvering,* 318 U. S. 322 (1943).
[41] Sec. 22(b) (12).
[42] Sec. 122.
[43] Sec. 710(c).
[44] Sec. 114(b) (2), (3) and (4).
[45] Sec. 117(b); there is an over-all tax limitation of 25% of the amount of such gain.
[46] Sec. 105 (applicable where the principal value of the property sold was demonstrated through prospecting, exploration or discovery by the taxpayer; the tax is limited to 30% of the selling price).
[47] Sec. 23(h).
[48] Reg. 111, Sec. 29.23(a)-16; CCH War Law Service, par. 41,072-041.
[49] Sec. 117(d) and (e); only 50% of the amount of the net long term capital losses are allowed as deductions, but only as offsets against corresponding gains. In the case of noncorporate taxpayers, $1,000 is the limit of the deduction in any taxable year, but not in excess of the net income; there is a five-year carry-forward provision.
[50] Secs. 23(a), (o) and (q).
[51] Sec. 23(j).
[52] Sec. 23(c).
[53] Secs. 23(a) (2) and (b).

of the "family" and through certain "controlled corporations,"[54] and also if expenses and interest, deducted by a taxpayer reporting on the accrual basis, are not paid to "related persons" within two and one half months after the close of the payor's taxable year.[55] Where an employer pays excessive compensation to an employee, the amount deemed excessive is disallowed as a deduction (although, of course, in business accounting the entire compensation would be treated as a deductible expense).[56] Finally, I should refer to the Code provision which taxes to the grantor of certain types of trusts income of which he has legally divested himself.[57]

I have already told you that some of the statutory deviations from approved accounting practices may, depending upon circumstances and future events, favor either the taxpayer or the Treasury. Time does not permit detailed reference, but see Code Sections 112, 124, 22(b)(2), 733, 23(a)(1)(c) and 24(a)(7).

VIII. LEGISLATIVE DISTORTION OF "ACCOUNTING INCOME"

We have seen that Congress has deliberately deviated from sound accounting practices in the defining of "taxable" income. Within the remaining area, however, it is unfortunate that there has not been stricter adherence to established accounting practices in the determination of net income. Offense is chargeable both to the courts and to the revenue authorities. I shall illustrate my point by reference to a single inter-related field, namely, liability reserves[58] and prepayments. In passing, I might say that with respect to liability reserves, part of the difficulty lies in accounting terminology: "reserves" are used in a number of senses, including the indication of accruals of liability. The statute permits deduction of reserves for bad debts, depreciation and depletion. Because of the specific statutory provisions, and because Congress has repeatedly resisted appeals to extend the use of reserves as deductions in the determination of taxable net income, the Treasury has refused to recognize other than specifically mentioned reserves, when denominated "reserves," even though they are for all practical purposes merely "accruals."[59] In this attitude the courts have generally, but not always, sustained the Treasury.

We have seen that Sec. 43 of the Code recognized accrued expenses as deductions. There is no conflict between the Treasury and the professional accountant as to the meaning of the "accrual basis" or the "accrual method of accounting." Long ago the Treasury recognized that true net income of a mercantile or manufacturing enterprise could not be determined on the basis of cash receipts and cash disbursement. This I pointed out earlier this evening. In speaking to a group of lawyers, perhaps I should not take it for granted that all are familiar with the meaning of "accrual method" and "accrual basis" of accounting, so I shall devote a few moments to the subject.

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[54] Sec. 24(b).
[55] Sec. 24(c).
[56] Sec. 23(a) (1) (A); Reg. 111, Sec. 29.23(a)-7.
[57] Secs. 166, 167; Reg. 111, Sec. 29.167-1(b).
[58] This discussion contemplates taxpayers other than insurance companies, reserves of which are deductible on a special basis. I.R.C. Sec. 201(b) (c) (2). *Ocean Accident & Guarantee Co., Ltd.* v. *Comr.*, 47F. (2d) 582 (C.C.A. 2, 1931).
[59] *Rogers, Brown & Crocker Bros. Inc.*, 32 BTA 307, 314 (1935); G.C.M. 9571, C.B. X-2, p. 153; Mertens, *Law of Federal Income Taxation*, 1942, vol. 2, sec. 12.67.

The Treasury's attitude toward an understanding of the accrual method of accounting is in accord with the views expressed by judicial tribunals. Thus, in *Spring City Foundry Co.* v. *Commissioner,*[60] the Supreme Court has held that keeping accounts on the accrual basis means that it is the *right* to receive and not the actual receipt that determines the inclusion of an amount in gross income. When the right to receive an amount becomes fixed, the right accrues.

The High Court, in the foregoing case, dealt with gross income. I now cite from a decision of the Board of Tax Appeals, which concerns itself both with income and with deductions on the accrual basis:

> "The basis idea under the accrual system of accounting is that the books shall immediately reflect obligations and expenses definitely incurred and income definitely earned without regard to whether payment has been made or whether payment is due. Expenses incurred in the operations for a particular year are properly accrued in the accounts for that year, although payment may not be due until the following year. Under the accrual system, the word 'accrued' does not signify that the item is due in the sense of being then payable. On the contrary, the accrual system wholly disregards due dates. *Neither is it necessary that the amount of an incurred liability be accurately ascertained in order to accrue it.*"[61] (italics supplied)

As descriptive of the accrual basis of accounting, it may be said that under this method, generally, the important and primary factor is not the receipt or the disbursement of cash, but the incurring or accruing of a right, and the incurring or accruing of an obligation. A sale of goods on credit, for instance, immediately creates an obligation on the part of the customer to pay for the merchandise involved, and the right on the part of the seller to receive the agreed price. When income is computed by the accrual method, consummated sales are deemed to result in income immediately, regardless of the date when payment is due. Likewise, when expenses are incurred, they constitute deductions from income immediately, even though the date of payment is postponed. [62]

A recent decision of the Circuit Court of Appeals for the Sixth Circuit aptly summarized requirements of the accrual method of accounting:[63]

> "The essence of the accrual method of keeping accounts and making returns is that the right to receive and not the actual receipt determines whether an amount should be included in gross income . . . Correspondingly, the right to deduct an expense item accrues when the fixed obligation is incurred, even though the amount may be diminished by subsequent events. Both sides of the ledger must be treated alike . . ."

It is patently unrealistic to include in income, under this system of accounting, amounts which the taxpayer's experience indicates will have to be paid over or returned to others,[64] or amounts which have not yet been earned.

I have already directed your attention to a firmly established accounting principle:

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[60] 292 U. S. 182 (1934).

[61] *H. H. Brown Co.*, 8 BTA 112, 117 (1927). But see *Brown* v. *Helvering, infra,* which holds that deductions for accrued liabilities must be predicated on definitely ascertained *amounts.*

[62] Klein, Federal Income Taxation, pp. 106-109.

[63] *Ohmer Register Co.* v. *Com'r,* 131 F. (2d) 682 (1942).

[64] Magill, *Taxable Income,* 1945, p. 209; *of Brown* v. *Helvering,* 291 U. S. 193, 199 (1934).

> The revenue of a given accounting period shall be charged with, and offset by, all costs and expenses fairly attributable or applicable to such revenue.

There is nothing in the statute to justify an assumption that Congress did not intend the foregoing definition to be recognized and applied in the determination of taxable income. Nevertheless, there are instances which demonstrate that taxing authorities are intent upon observing the requirements of the accrual basis with respect to gross income but much less zealous of doing so with reference to deductions therefrom.

A number of rent pre-payment cases will illustrate my point. In the *De Golia* case[65] the Board, and in the *Renwick* case[66] the Seventh Circuit Court, held, with respect to taxpayers reporting income on the cash receipts and disbursements basis, that rent received in advance was taxable in the year of receipt, where no "strings" were attached to the receipt, *i. e.*, the recipient was under no liability to return the advance rent, nor was there any obligation to keep such rent in a special fund for specific purposes, or to apply it to the payment of future taxes on the property. Said the Court in the *Renwick* case:

> "If a taxpayer receives earnings upon property under a claim or right and without restriction as to its disposition, he has received income for which he is required to account."

Even if cash basis taxpayers are held subject to income tax for advance rent, in the year of receipt, there is no accounting excuse for such treatment of taxpayers on the accrual basis. Nevertheless, it was so decided in the *Amusement Company* case,[67] where the Board held that an advance rental "was not merely a deposit as security for the performance of some provision of the lease" and therefore had been received as rent without restriction.

In another case also involving a taxpayer on the accrual basis, the Circuit Court of Appeals for the Fifth Circuit held, properly, that advance rental for the tenth year of the term was a mere deposit and not taxable income at the time of receipt where such advance was given as security for the performance of the lessee's contractual undertakings, even though there was no requirement to maintain a separate fund for the advance rental and the cash in question was intermingled with the lessor's other funds.[68] The prepayment was available as damages in the event of failure to perform, and the lessor allowed interest to the lessee on the amount. In the *Astor Holding Company* case,[69] the same Circuit Court, a year later, affirming a memorandum opinion of the Board, held that a taxpayer, on the accrual basis, was taxable in the year of receipt for advance payment of rental for the tenth year of the term. The Court differentiated the facts in the instant case from those of the *Clinton Hotel* case by emphasizing that in the later case the payment was absolute, whereas in the earlier case there were a number of conditions which might make an advance applicable otherwise than as rent for the tenth year. There is no accounting justification in the case of accrual basis taxpayers for treating as income in the year of receipt, advances of rental for a future period. As I have indicated, however, the Treasury and the courts refuse to follow sound accounting practice except in instances where the advance is subject to such restrictions as those which existed in the *Clinton Hotel* case.

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[65] 40 BTA 845 (1939).
[66] *Renwick v. U. S.*, 87 F. (2d) 123 (1937).
[67] *H. & G. Amusement Co., Inc.* v. *Com'r*, 46 BTA 1095 (1942).
[68] *Clinton Hotel Realty Corp.* v. *Com'r*, 128 F. (2d) 968 (1942).
[69] *Astor Holding Co.* v. *Com'r*, 135 F. (2d) 47 (1943).

We shall soon see that the attitude toward "accrual deductions" is not always consistent with that shown toward "income accruals." Consider prepayments. Take, for example, payment of commissions for negotiating a lease. We noted in the *Renwick* case that the prepayment of rent was held income in the year of receipt. Nevertheless, the commission paid the rental agent who obtained the lease was held to be *not* deductible in the same year but was to be prorated over the life of the lease!

Unfortunately, rent and lease commission cases are not the only ones in which the Treasury exhibits inconsistency and in which the courts sustain such inconsistency. Perhaps the *South Tacoma Motor Co.* case[70] illustrates, as pointedly as any other, disregard of sound accounting principles. In that case the taxpayer sold service coupon books for cash. As the buyers received service, coupons were delivered; purchasers had the right to have unused coupons redeemed in cash. The taxpayer, on the accrual basis, consistently reported as income that portion of sales represented by coupons collected for services rendered. The Commissioner increased income by adding the deferred portion of the service coupon sales and the Board sustained him. There is no accounting justification[71] for the administrative action and, of course, for the Board's approval thereof. There is no statutory mandate for the Commissioner's action in the *Tacoma* case; none of the statutory provisions which deliberately deviate from sound accounting principles apply to the transaction in question. In fact, not only did the Commissioner ignore sound accounting principles consistently applied, but he substituted therefor a hybrid cash-accrual method of determining income: he accepted the taxpayer's accrual method with respect to all other items of income and deductions but asserted tax on the basis of cash receipts with respect to service coupon sales.

A case with facts decidedly analogous to those of the *Tacoma* case is *Your Health Club, Inc.*[72] In that case, the Club sold for cash a year's "gym" service,—a sort of membership privilege. Sales were made continuously, so that during any taxable year there were overlapping service sales: sales of the prior year expired during the given year, while sales during the given year did not expire until the succeeding year. While the arrangement did not expressly provide for refundment in the case of surrender of membership, refunds on a proportionate time basis were made upon request. The taxpayer, during its brief existence, had consistently reported as gross income the portion of membership dues which had expired during the taxable year. The Tax Court, in holdings that the entire cash received for service membership constituted income in the year of receipt, assumed that refundment might never be requested. This is true, of course, but then the cost of rendering the purchased and prepaid services: rent, heat, light, salaries, etc., would inevitably have to be met, to some extent, in the period subsequent to the end of the taxable year in which the "dues" were received.

In response to the taxpayer's arguments in the *Club* case that the inclusion of prepaid amounts in the income of the year in which received "prohibits a correlation of income and expenses incident to the earning of that income," the Court pointed out the rather cum-

[70] 3 T. C. 411 (1944).

[71] Melvoin, "Reconciliation of Conflicting Accounting and Tax Concepts of Income" in American Institute of Accountants papers read at 1944 annual meeting; Montgomery, "Administrative Tax Accounting Fallacies in Section 41," 78 Journal of Accountancy, 14; Gutkin and Beck, "Tax Accounting v. Business Accounting—The Emasculation of Section 41," 79 Journal of Accountancy 130.

[72] 4 T. C. 385 (1944).

bersome remedial procedure provided in the regulations[73] to implement Code Section 43 which permits deductions in a period other than the taxable year in which paid, incurred or accrued, if necessary in order clearly to reflect income. Regardless of the extent to which this exception may alleviate the situation, as regards deductions, the fact remains that the inclusion in gross income of the accrual basis taxpayer of receipts as yet unearned does violence to sound accounting principles.[74]

The cases to which I have referred, and many others which reach similar results, frequently cite as authority the case of *Brown* v. *Helvering, supra,* the leading case on the question of contingent liability reserves.

The Supreme Court has acknowledged that the prudent business man often sets up reserves to cover contingent liabilities.[75] A proper interpretation of Code Sec. 41 recognizes such reserves as exclusions or deductions from gross income. But the High Court, in the *Brown* case, disapproving a liberal and realistic decision of the Circuit Court for the Fourth Circuit[76] which had approved deduction of reserves for cash discounts to which the taxpayer's accounts were subject, in an amount determined by past experience with reasonable accuracy at the end of the taxable year, established an unrealistically narrow criterion of deductibility requiring the liability provided against in the reserve to be fixed and absolute as opposed to merely contingent. In the *Brown* case, the so-called contingency consisted of the very strong probability based on previous experience that a general agent of fire insurance companies might be required, because of cancellation of policies, to return a portion of overriding commissions. This contingency was held not to justify the deduction of a reserve set up to meet the obligation to refund. The additional factor in the case that the taxpayer's attempt to deduct the reserve constituted an *inconsistent* method of accounting for which the Commissioner's consent had not been secured, renders the decision sound. That most courts have adopted the alternate basis of decision and rigorously disapproved reserves for contingent liabilities constitutes, it seems to me, a faulty conception of the requirement of Code Section 41 and the rationale of the rule in *U. S.* v. *Anderson, supra.*[77]

It is of course within the province of a court to find upon the facts before it that a liability for which a reserve has been established is not contingent, but absolutely accrued. Liberality in this respect has distinguished a few decisions. Most noteworthy is the line established by *Air-Way Electric Appliance Corp.* v. *Guitteau*[78] in which the taxpayer set up a "Reserve for Contingent Collection Expense" attributable to its liability for distributors' commissions payable as installments of the sales price were paid. Denying that the liability was a contingent one under the rule of *Brown* v. *Helvering,* the Court held that the obligation to pay commissions was absolute and accrued when the right to collect accrued during the taxed years. The "reserve" did not, therefore, constitute taxable income.

To the same effect are the rulings in

[73] Regs. 111, Sec. 29.43-1; 103, Sec. 19.43-1.

[74] See I. T. 3740, 1945-11—12050 (p. 3) for a proper application of accounting principles to deductions for prepayment of interest.

[75] *Lucas* v. *American Code Co., Inc.,* 280 U. S. 445 (1930); *Brown* v. *Helvering, supra,* I. T. 2199, C. B. IV-2, 78.

[76] *Virginia-Lincoln Furniture Corp.* v. *Com'r,* 56 F. (2d) 1028 (1932) citing Klein, *Federal Income Taxation,* p. 137.

[77] Montgomery, *Federal Taxes on Corporations,* 1944-45, p. 975. *Cf. Shapleigh Hardware Co.* v. *U. S.,* 81 F. (2d) 697 (C.C.A. 8, 1936); G.C.M. 1342, C.B. VI-1, 177.

[78] 123 F. (2d) 20 (C.C.A. 6, 1941), rev'g. 29 F. Supp. 379.

Ohmer Register Co. v. *Com'r.*,[79] and *Warren Co., Inc.* v. *Com'r.*,[80] wherein the respective taxpayers were held entitled to accrue in the taxable year, as a deductible selling expense, the entire amount of reserves for sales agents' commissions.[81] In the *Ohmer* case, the Court, recognizing that "both sides of the ledger must be treated alike" if the method of accounting adopted was to clearly reflect net income, declared:

> "The fact that the agent might not in the end receive his full commission is no more material than that the petitioner might not receive full payment of the purchase price of the article sold. * * *
>
> "To divide the sale transactions here involved so as to treat them upon an accrual basis with respect to income and upon a cash basis with respect to expense in commissions in making sales from which the income was derived would be as objectionable as the division condemned in Air-Way Electric Appliance Corporation *v.* Guitteau."

An exception to the narrow formula applied to liability reserves is promulgated in the Regulations[82] for situations where trading stamps and premium coupons redeemable in merchandise or cash are issued for business promotion purposes. The distributor of such stamps or coupons may deduct from gross income the sum necessary to redeem such part issued for the taxable year as experience indicates will be presented for redemption. An unexpended portion of a reserve set up for stamps or coupons is taxable in the year of its transfer to surplus.[83]

For the rest, while it is the rigid rule that a reserve reflecting a contingent liability is not allowable as a deduction or exclusion from gross income, it will be true, as a practical matter, that the taxpayer's method of accounting is not being permitted to "clearly reflect the income."

Unfortunately, the taxing authorities have been amply supported in their distortion of accounting concepts by a judicial, albeit erroneous, distinction between "net income" and "net earnings." Thus, in *South Dade Farms, Inc.* v. *Commissioner*, 138 F. (2d) 818 (C.C.A. 5, 1943), the Court stated that "Section 41 . . . required that the method of accounting should clearly reflect income, not net earnings." Likewise, in the *South Tacoma* case, *supra*, which involved prepayments by way of purchase of service coupon books, the Tax Court found that the taxpayer received its *income* in the year of prepayment, though its *earnings* therefrom might be subject to expenses in a later year[84] (not to mention redemption of unused coupons).

IX. CONCLUSIONS.

If one versed in accounting were to read for the first time the sections of the law and the Commissioner's regulations interpretative thereof, as set forth in tonight's lecture, he could reasonably conclude that sound accounting principles, consistently applied, would be determinative of taxable income. We

[79] 131 F. (2d) 682 (C.C.A. 6, 1942), rev'g. B.T.A. Memo. Dec.

[80] 46 B.T.A. 897 (1942) Acq. 1942—2 C.B. 19, aff'd, 135 F. (2d) 697 (C.C.A. 5, 1943).

[81] *Cf. Reuben H. Donnelley Corp.* v. *Com'r*, 22 B.T.A. 175 (1931) Acq. X-2 C.B. 19, where amounts due for commissions were not credited until payment of the accounts.

See also *Willoughby Camera Stores, Inc.*, v. *Com'r.*, 125 F. (2d) 607 (C.C.A. 2, 1942), rev'g 44 B.T.A. 520.

[82] Reg. 103, Sec. 19.42-5. See also Regs. 101, 94, 86; Art. 42-5; Regs. 77, 74; Art. 335; Regs. 65, 62, Art. 91; Reg. 45, Art. 88.

[83] *The Creamette Co.*, 37 B.T.A. 216 (1938).

[84] *CF.* I.T. 3369, C.B. 1940-1, 46, permitting accrual basis publishers receiving prepaid subscriptions to employ both deferred income and deferred expense accounts in arriving at net earnings.

have seen, however, that Congress has specifically departed from ordinary accounting principles and practices by wholly or partially excluding from income items which the accountant regards as income, by including items not regarded by the accountant as income, by refusing to allow deductions which the accountant would subtract from gross income in the process of determining net income, by allowing certain deductions in a given period which do not really belong to the operations of that period, and otherwise.

We have no special quarrel tonight with statutory inclusions or exclusions, or with postponements and precipitation of income. We merely refer to these matters to focus attention on the fact that taxable income cannot, in many situations, be exactly the same as financial or business income. Nevertheless, in saying this, we wish to emphasize that, aside from statutory differences, Congressional intent is, or at least was, to have sound accounting principles, consistently applied, determine taxable income. We have seen too many instances in which such inference or belief has been ignored; court approval, and sometimes initiation of the trend itself by the courts, have created situations that should never have been permitted to arise and, surely, should not be permitted to continue.

We have seen that accountants are prone to resist recognition of profits until they become certain, and to anticipate expenses and losses. The federal income tax law recognizes only to a limited extent this conservative practice. Inventorying at cost when market is higher, and at market when cost is higher, is a concession to good accounting practice. So is the statutory provision for bad debt reserves. But it is difficult to excuse the deliberate and long-continued refusal to permit reserves for contractual commitments of machinery manufacturers, building and other construction contractors, and others who must guarantee their products. The recent loss carry-back and carry-forward provisions may be interpreted as a species of reluctant confession of past legislative error with respect to reserves for the indicated purposes and for other probable losses and expenses where neither the exact amount nor the precise time of occurrence can be foretold, although experience justifies the conclusion that such expenses and losses will occur. And it is likewise difficult to accept, and quite impossible to excuse, insistence that prepayments for future services should be taxed as income in the year of receipt.

In *Dobson* v. *Commissioner,*[85] Mr. Justice Jackson points out that after thirty years of income tax history, there is no indication, contrary to normal expectation, that tax litigation will subside. He does not refer so much to frequent amendments of the law as the cause, because he knows that some amendments are necessitated by court decisions. The fault lies, he declares, in the fact that tax decisions of the courts are "not based on statute but upon their ideas of right accounting or tax practice." He then continues:

> "But conflicts are multiplied by treating as questions of law what really are disputes over proper accounting. The mere number of such questions and the mass of decisions they call forth become a menace to the certainty and good administration of the law."
>
> * * *
>
> "Whatever latitude exists in resolving questions such as those of proper accounting . . . exists in the Tax Court and not in the regular courts."

We have seen how far the Treasury has departed from accepted accounting principles in the treatment of accruals, of prepayments and other deferred

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[85] 320 U. S. 489 (1943).

items. Its action has been encouraged by the courts. The Supreme Court's recognition of the primary judicial status of the Tax Court may inspire that tribunal to re-examine and, at an early opportunity, rectify the type of accounting errors which I pointed out to you this evening. It may be that the remedy lies in legislation. Congress should, at the earliest possible opportunity, restate its views and intendment, in language even clearer than the clear language of Sections 41, 42 and 43. To recognize net income, determined by the application of accepted accounting principles consistently applied, as synonymous with taxable income, save only as the latter is specificially modified by statute, would make for greater clarity and certainty in the law, would avoid much unnecessary litigation, and would probably in the long run not injure the revenue. Lawyers and accountants are familiar with many instances in which the Commissioner's action in ignoring sound accounting resulted in some immediate collection of revenue, offset, however, by considerable more revenue loss in later years.

Corporate Consolidations, Reorganizations and Mergers

Principal accounting issues incident to the combination and reorganization of business enterprises

By J. ARTHUR MARVIN, C.P.A.

MY remarks tonight will be confined to the principal accounting issues incident to consolidations, mergers and reorganizations of business enterprises. In this era of high taxation, any plan that may be devised for the consolidation, merger or reorganization of corporate enterprises must first take into consideration the federal tax problems involved. They are of paramount importance to not only the corporations involved, but to the interested creditors and equity shareholders. Inasmuch as these tax problems have already been presented to you, I will confine my remarks to a discussion of accounting problems and issues. Mr. Wernz will probably discuss tonight the rules and regulations of the Securities and Exchange Commission governing consolidations, mergers and reorganizations, and particularly the applicable accounting series releases. Their importance cannot be overemphasized. They should be carefully studied whenever a consolidation, merger or reorganization is contemplated.

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First there must be a carefully considered plan. In the development of this plan, too much emphasis cannot be placed upon the importance of the contribution that can be made by the legal and the accounting professions. This calls for the closest cooperation between the attorneys and the certified public accountants for the interested parties. The attorney must pass upon the legality of the proposed consolidation, merger or reorganization, the plan and the tax problems involved. The certified public accountant must pass upon the applicable accounting principles and the tax problems involving accounting issues under the applicable laws and regulations issued by the taxing authorities. In passing upon the applicable accounting issues, it should be noted here that the American Institute of Accountants has developed through its Committees on Accounting Procedure and Auditing Procedure certain guiding principles for business enterprises and for the accounting profession, which set forth the generally accepted accounting principles to be applied in the treatment of many items that come up for accounting interpretation, not only in connection with the published

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annual reports of commercial enterprises, but also when plans are being formulated for prospective consolidations, mergers and reorganizations. Therefore, in the development of these plans the interested corporate officials, their attorneys and certified public accountants, should work in the closest cooperation in order that no plan will be devised which will ultimately result in transactions which will compel the independent certified public accountant to qualify and take exception in his report and opinion with respect to annual reports issued by companies subsequent to the consolidation, merger or reorganization. Such qualifications or exceptions could have an adverse effect upon the future operations of the companies.

A study indicates that some confusion exists in the statutes, in that some statutes do not make a clear line of demarcation between consolidations and mergers. From the accounting viewpoint there is a distinction between a consolidation an a merger. To the accountant a consolidation results when the shareholders of two or more corporations have agreed that it would be to the interest of all concerned to consolidate their enterprises in the interest of economy and thereby improve the net income result of the combined interests. In the case of a consolidation, a new corporation is usually organized with an entirely new charter which acquires all of the assets and assumes all of the liabilities of the corporations party to the consolidation agreement in exchange for stock of the new corporation. Usually, all of the capital shares of the old companies are surrendered and their charters cancelled. A merger is considered distinct from a consolidation in that one corporation may acquire all of the outstanding shares or acquire all the assets and assume all of the liabilities of one or more other companies, and, simultaneously with such acquisition or at a later date, the assets and liabilities of the acquired company or companies are merged into the acquiring company and the acquiring company is the surviving or continuing company. Also, in the case of a merger it is usual, where the statutes so provide, that all the rights existing under the charters of companies merged into the surviving or continuing company, are preserved and the charters of the merged companies become part of the charter of the surviving or continuing company.

Reorganizations generally take one of three forms. Reorganizations under Chapter 10 of the Bankruptcy Act, reorganizations or readjustments accomplished through creditor committees, and quasi-reorganizations which are generally accomplished through appropriate action of the directors and stockholders.

Reorganizations under the Chandler Act are under the jurisdiction of the courts who have discretion as to whether or not they appoint a trustee independent of the management or permit the existing management of the company to act as trustee and continue to operate the business during the reorganization period. Generally, in each instance, the records of the company involved are carried on as heretofore with the possible exception that as of the date of the appointment of the trustee new accounts are opened to which are transferred all of the assets and liabilities of the company so as to establish a clear line of demarcation for the purpose of permitting the trustee to give a clear report of his stewardship from the date of the trusteeship. Generally, protective committees are formed for the purpose of protecting the interests of the various classes of creditors as well as the various classes of stockholders. The trustees generally work in cooperation with these com-

mittees in developing a plan of readjustment which will meet with the approval of all interested parties. Usually, the plan of reorganization provides for the scaling down of the funded debt and the interest thereon, or the possible substitution therefor of income bonds or capital stock, the elimination of one or more classes of preferred shares and the possible substitution of common shares for preferred, and the scaling down of the interests of, or the elimination of, the common shareholders. This also involves an adjustment of the interests of other creditors and such adjustment may provide that the creditors will receive settlement in the form of cash or securities or part in cash and part in securities of the reorganized company. In cases where reorganizations or readjustments are accomplished through creditor's committees, such committees usually avoid going through the courts and endeavor to work out a plan, if the business is sound, either by a scaling down of liabilities or by other means reestablish the business on a sound basis and save the company from bankruptcy. In the case of a quasi-reorganization, however, we have a situation where the management of a company submits a plan to the stockholders whereby a readjustment is suggested of the capital structure of the company for the purpose of creating a capital surplus against which write-downs of asset values may be made and existing operating deficits may be eliminated. This is usually done where a company has been over-capitalized and has been unable to operate profitably because of heavy financial charges against income, and it is considered desirable to relieve future income of these charges. A quasi-reorganization presents a number of economic and accounting problems which require very careful consideration where such type of reorganization is contemplated.

In the foregoing I have tried to give you the accounting viewpoint or concept of consolidations, mergers and reorganizations. Because many of the accounting problems or issues are common to all, I will try to present them from the standpoint of the balance sheet or statement of assets and liabilities as it is sometimes called. It should be emphasized that these accounting problems or issues should be dealt with before consolidation, merger or reorganization. If they have to be met after consolidation, merger or reorganization they may jeopardize the future operations of the enterprise.

In a well prepared balance sheet, the assets and liabilities are grouped under major classifications. The assets will be grouped under current assets, property, plant and equipment, other assets or investments, and deferred assets or charges. The liabilities will be grouped under current liabilities, funded or other long-term debt, deferred income or credits, reserves, capital stocks and surplus.

Current assets usually consist of cash, marketable securities, notes and accounts receivable, and inventories which are generally divided into raw materials, work in process, finished goods and supplies. Cash and cash items should be investigated to determine whether any of the cash is restricted for specific purposes and that no unusual items are carried as cash, such as advances to officers, employees or others, in which case definite arrangements should be made for settlement. Marketable securities should be carefully examined, and where it is determined that the quoted market value of such securities is below cost, adjustment should be made. Where the quoted market value of these securities are in excess of cost, it is usual to adjust them to the quoted market value. Notes and accounts receivable due from cus-

tomers should be carefully reviewed and accounts known to be uncollectible written off. An adequate reserve should be provided for accounts which appear to be doubtful of collection. Arrangements should be made for the collection of any amounts due from officers or employees. If not considered collectible, they should be charged off or an adequate reserve provided to cover possible losses. Other receivables should also be reviewed and treated accordingly. Inventories should be carefully taken and priced under the supervision of the independent certified public accountant and a competent appraiser. All materials, work in process, finished goods or supplies which are determined to be shopworn, obsolete or unusable should be reduced to their scrap or realizable value less provision for profit on sale. If it is determined that any of the current assets have been pledged as collateral to secure the payment of loans payable, such pledged assets should be shown separately. The foregoing procedure should be applied to all companies which are a party to or are involved in a consolidation, merger or reorganization.

Because of the importance of the relationship of the current liabilities to the current assets, I feel that these should be discussed at this point. The current liabilities generally consist of notes payable due to banks and others, accounts payable due to trade creditors and others, and accrued items such as payrolls, state, local and federal taxes. Notes payable are generally taken over at their face amount in the case of consolidations and mergers, but in reorganizations these usually have to be scaled down to conform to the final agreements reached with the creditors. Such scaling down usually follows the order of priority in cases where some notes payable may have been secured by the deposit of collateral. Accounts payable due to trade creditors will be treated similarly and scaled down in accordance with the agreement with the creditors. Payrolls have a prior lien against the assets of the companies and are generally paid in full. State and local taxes are a lien against the property taxed and may have to be paid in full. Likewise federal withholding, social security and federal income and excess profits taxes have priority over other creditors to the extent established by law. There have been instances where state, local and federal taxes have been compromised and substantial downward revisions obtained. This possibility should be explored by the attorneys. All of these tax accruals should be carefully computed and the estimates made should be reasonably accurate. In the case of federal income and excess profits taxes a careful review should be made of all of the federal income tax returns filed which have not yet been examined by the Bureau of Internal Revenue. It may be found that a number of questions of law and accounting exist which may result in additional assessments of a substantial nature. Many of these questions may not yet have been settled by the Courts or by the Bureau of Internal Revenue and these matters should be brought to the attention of the attorney of the company so that legal as well as the accounting aspects of the items in question may be thoroughly studied and opinions obtained as to the possible ultimate tax result. If necessary, additional provisions should be made to cover possible additional assessments. All other current liabilities should be carefully investigated. The foregoing review of current liabilities is important in consolidations and mergers, where reorganization is contemplated under Chapter 10 of the Federal Bankruptcy Act, or through a creditors'

committee. Usually in a quasi-reorganization there is no scaling down of current liabilities unless there happens to a major liability due to an affiliated company.

Property, plant and equipment and the related reserves for depreciation involve both problems of accounting and valuation. Usually in well managed companies property, plant and equipment is generally stated at cost and the company has adopted a consistent method of providing for appropriate charges to income for depreciaton and has provided a reserve to measure the accumulated exhaustion, wear and tear on the property. Usually in the case of consolidations and mergers, property, plant and equipment is taken into the new or surviving company at the gross amount representing the cost of property, plant and equipment to the companies and the full amount of the accumulated reserve for depreciation is taken over. Sometimes a party to the consolidation or merger may claim that its policy with respect to depreciation, maintenance, additions and betterments, has been more conservative than that of one or more of the other companies involved and for this reason its plant accounts and depreciation reserve should be adjusted. In any event, the plant account should be carefully reviewed and adjustments made which will reflect as nearly as possible the cost of the property and accumulated depreciation thereon. A method that is sometimes used is for the company or companies to have appraisals made of the property and to adjust the property values up or down as the case may be before consolidation or merger is effected. These values should be on a conservative basis because the values that flow into a consolidated company will be used as the basis for determining future charges against income for depreciation. If the valuations are high and after consolidation and merger require a substantial increase in the amount charged against income for depreciation, such increase may impair the success of the combined companies by substantially reducing the profits resulting from the combination. Where a reorganization is contemplated under Chapter 10 of the Federal Bankruptcy Act or where a quasi-reorganization is contemplated, the property, plant and equipment may be subject to substantial reductions in order to eliminate obsolete plant, machinery and equipment. In any event, it is advisable to have the report of competent engineers as to the utility of property, plant and equipment in order to avoid the mistake of carrying these properties into the reorganized company's accounts at too high a valuation. To illustrate this point, a recent situation came to my attention with respect to a company which had been reorganized about ten years ago under Chapter 10 of the Federal Bankruptcy Act involving the acquiring of the properties of the company under reorganization which included a couple of idle plants. At the time they were acquired the management of the reorganized company felt that it would be able to develop enough business to use these plants on a profitable basis. It subsequently developed that this hope was not realized and an opportunity arose for the sale of one of the idle plants. The plant was sold for a nominal sum and resulted in a net loss after taxes of approximately $400,000.00. The company since the date of reorganization had accumulated a sizable earned surplus and found that because it was compelled to charge this substantial amount against its earned surplus that the earned surplus accumulated since the date of reorganization had been reduced by approximately one-half. This is a

condition which cannot always be avoided and rests upon the best judgment of the interested parties at the time of the reorganization. But another factor that entered into this was that depreciation, taxes and other expenses applicable to this idle plant and equipment had to be charged each year against current income which reduced the results of operations of its operating plants. If this situation could have been foreseen at the time of the reorganization of the company and these idle properties taken over at a nominal figure, the net income of the company would have been improved to the extent of such charges and it would not have been necessary to have used one-half of the earned surplus accumulated since the date of reorganization to absorb losses when this plant was sold.

Other assets usually include long-term investments, such as investments in other companies, property not used in operations, patents, patent rights, and similar intangibles and goodwill. Usually the securities or investments held under this classification are of a nature which are not readily marketable. Investigation should be made to determine whether or not any investments in stocks and bonds have a quoted market value and if the quoted market value is less than the cost, adjustment should be made to reflect their value as of the date of the consolidation, merger or reorganization. On the other hand, if the market value is in excess of cost, adjustment upward may be appropriate. Mortgages included under this caption should be carefully reviewed from the standpoint of the type and character of the property pledged to secure the mortgage. If it appears that the value of the properties securing these mortgages does not warrant a recognition of the full amount of the mortgages then adjustments should be made to conform with the estimated realizable values of such mortgages. Investment in other companies may include investments in wholly owned subsidiaries. Careful review should be made of the financial statements of these subsidiaries. If it is determined that the cost of these investments is substantially in excess of the net worth of these subsidiaries as shown by the latter's books, adjustment should be made. In this connection it may be found that a company had substantial investments in foreign subsidiaries and that such investments were charged off the books in order to take advantage of deductions as permitted under the Internal Revenue Code. With the end of the war in Europe it may be found that many of the plants of these foreign subsidiaries have not been seriously damaged. The company may recover most of its investment and resume the management and operation of these foreign subsidiaries. The recovery of these properties presents a difficult accounting, valuation and tax problem. Many companies carry patents, patent rights and similar intangibles at a nominal figure on their books, and others may show a substantial investment in these items. While these patents have probably been thoroughly investigated from the legal standpoint, careful investigation has to be made from the accounting standpoint to see that proper amortization has been charged against income in prior years so that future income will not be burdened with these charges. Usually in a reorganization patents, patent rights and similar intangibles are valued at a nominal amount so as to relieve future income of amortization charges.

Goodwill is an item that requires careful analysis and consideration. If in the process of consolidation or merger by reason of having paid a price higher than book value, good-

will is acquired through the purchase of capital stock of one or more of the consolidating or merging corporations, consideration has to be given to whether or not this goodwill is liable to become a charge against future income or earned surplus. This also applies to reorganizations.

The American Institute of Accountants recently issued Research Bulletin No. 24 dealing with the subject of intangibles. In this bulletin the intangibles are broadly classified as follows:

(a) Those having a term of existence limited by law, regulation or agreement, or by their nature (such as patents, copyrights, leases, licenses, franchises for a fixed term, and good-will as to which there is evidence of limited duration).

(b) Those having no such limited term of existence and as to which there is, at the time of acquisition, no indication of limited life (such as goodwill generally, going value, trade names, secret processes, subscription lists, perpetual franchises and organization costs).

(c) The excess of a parent company's investment in the stock of a subsidiary over its equity in the net assets of the subsidiary as shown by the latter's books at the date of acquisition, insofar as that excess would be treated as an intangible in consolidated financial statements of the parent and the subsidiary. This class of asset may represent intangibles of either type (a) or type (b) above, or a combination of both.

In discussing the various types of intangibles, the committee made the following statements:

(1) The initial carrying value of all types of intangibles should be cost, in accordance with the generally accepted accounting principle that assets should be stated at cost when they are acquired. In the case of non-cash acquisitions, cost may be determined either by the fair value of the consideration given or by the fair value of the property acquired whichever is the more clearly evident.

(2) The cost of type (a) intangibles should be amortized by systematic charges in the income statement over the period benefited, as in the case of other assets having a limited period of usefulness.

(3) The cost of type (b) intangibles may be carried continuously unless and until it becomes reasonably evident that the term of existence of such intangibles has become limited, or that they have become worthless. In the former event, the cost should be amortized by systematic charges in the income statement over the estimated remaining period of usefulness or, if such charges would result in distortion of the income statement, a partial write-down may be made by a charge to earned surplus, and the balance of the cost may be amortized over the remaining period of usefulness. If an investment in type (b) intangibles is determined to have become worthless, the carrying value should be charged off either in the income statement or to earned surplus as, in the circumstances, may be appropriate. In determining whether an investment in type (b) intangibles has become, or is likely to become worthless, it is proper to take into account any new and related elements of intangible value, acquired or developed, which have replaced or become merged with such intangibles.

(4) Where a corporation decides that a type (b) intangible

may not continue to have value during the entire life of the enterprise, it may amortize the cost of such intangible despite the fact that there are no present indications of such limited life which would require reclassification as type (a) and despite the fact that expenditures are being made to maintain its value. In such cases the cost may be amortized over a reasonable period of time, by systematic charges in the income statement. The procedure should be formally approved, preferably by action of the stockholders, and the facts should be fully disclosed in the financial statements. Such amortization is within the discretion of the corporation and is not to be regarded as obligatory.

(5) There is a presumption, when the price paid for a stock investment in a subsidiary is greater than the net assets of such subsidiary applicable thereto, as carried on its books at date of acquisition, that the parent company, in effect, placed a value greater than book value on some of the assets of the subsidiary in arriving at the price it was willing to pay for its investment therein. If practicable, there should be an allocation of such excess as between tangible and intangible property and any amount allocated to intangibles should be further allocated to determine a separate cost for each type (a) intangible, and for at least the aggregate of all type (b) intangibles. The amounts so allocated to intangibles should thereafter be dealt with in accordance with paragraphs (1), (2), (3), and (4) hereof.

(6) In connection with the foregoing procedures, the committee recognizes that in the past it has been accepted practice to eliminate type (b) intangibles by writing them off against any existing surplus, capital or earned, even though the value of the asset is unimpaired. Since the practice has been long established and widely approved, the committee does not feel warranted in recommending at this time adoption of a rule prohibiting such disposition. The committee believes, however, that such dispositions should be discouraged, especially if proposed to be effected by charges to capital surplus.

These factors should be given serious consideration in a consolidation, merger or reorganization, because of their possible effect upon the future earning power of the companies. Companies being reorganized under Chapter 10 of the Federal Bankruptcy Act, and particularly companies contemplating a quasi-reorganization are affected because these companies usually have been unable to operate at a profit on the basis of their existing capital structure. In such cases it seems reasonable to assume that goodwill is of no value and should not be capitalized. This reasoning may also be applied to patents, copyrights and other intangibles. This is not always true, however, in the case of consolidations or mergers where the continuing corporation may derive substantial benefit by reason of the goodwill or other intangibles acquired.

Deferred assets and deferred charges to future operations should be carefully reviewed, and any amounts reduced or added depending upon the result of the investigation. In this connection we sometimes have a substantial adjustment for unamortized debt, discount and expense, where before the consolidation, merger or under the plan of reorganization the funded debt is paid off or otherwise disposed of.

Funded debt or other long-term debt may be taken over at face

amount in consolidations or mergers, depending upon the terms of the agreements. Usually, where any debt discount and expense exists, such items are taken over at the amount recorded on the predecessor's books and are amortized over the remaining life of the bonds. In reorganizations under Chapter 10 of the Federal Bankruptcy Act, we usually have a scaling down of this funded debt and a substitute of another type of long-term debt or capital stock. In reorganizations by creditors' committees, these are matters which are adjusted by agreement between the various creditors at interest. In quazi-reorganizations, funded debt is usually not affected.

Deferred income and credits should be reviewed. Usually deferred income represents income received in advance of the performance of the service for which it was received. If it appears evident that the cost of performance of the service will exceed the deferred income, additional reserves should be provided to cover any additional costs. Deferred credits are usually items, the final disposition of which has not yet been determined. These should be investigated and appropriate disposition made if the necessary information is available.

Many types of reserves may be found on the books of some of the companies. The purpose of these reserves should be carefully investigated, and if found to be no longer required for the purpose for which they were originally provided, they should be restored to earned surplus where such reserves were established through charges against income in prior years. On the other hand, if they happen to comprise self-insurance reserves or other reserves that were established to protect the company against an anticipated liability, careful investigation should be made to see that the reserves are adequate. Under present conditions, substantial reserves for contingencies may be found on the books of many companies. The main purpose today is to protect the company against future war contingencies, such as excessive cost of reconverting their plants from war production to the manufacture of consumer products.

A company may have established substantial reserves for anticipated losses arising out of the war. These reserves may have been provided to protect the company against possible losses due to war damage to plants located in foreign countries. These require careful review and may be subject to adjustment in the light of the termination of the war in Europe and the possible recovery of these properties. These reserves can be substantially in excess of or below requirements and a careful review should be made of the purposes for which they were created, and should be adjusted to fit the situation at the time of consolidation, merger or reorganization.

Capital stock usually does not involve any unusual accounting issues. In the case of consolidations, the capital stocks of the corporation organized to acquire the assets and liabilities of the company to be consolidated is usually issued in exchange for the stock of the companies party to the consolidation. In the case of a merger, the capital stock of the companies being merged into the surviving or continuing company are surrendered and cancelled. In the case of a reorganization, the capital shares to be issued to creditors or to former stockholders are clearly set forth in the agreements and should be accordingly recorded on the books of the continuing company. Or, if a new company is organized to acquire the assets of the old company, the capital stock will be issued in

accordance with the reorganization agreements.

The next problem that I wish to discuss is the treatment of the surplus account of the combined companies. In the treatment of the combined surpluses, not all accountants agree, so that I will have to straddle this issue to some extent and only try to give you the different points of view. The weight of opinion at the present time, as it relates strictly to the consolidation of two or more companies, appears to be that because an entirely new company emerges when a consolidation is effected, any earned surplus that may exist on the records of either or all of the consolidated companies should be carried in the capital surplus account of the emerging company, and that a new earned surplus account should be started which is to be dated from the date of consolidation. Another method is to carry the combined earned surpluses of the old companies into the books of the emerging corporation as earned surplus of the combined companies at the date of consolidation and then to earmark the earned surplus since the date of consolidation. When issuing balance sheets of the new company, these two earned surplus accounts would be shown so that investors may see the accumulation of undistributed earnings since the date of consolidation. This would enable the investor to judge whether or not the consolidation had been successful and had lived up to its expectations as far as earning power is concerned. There is one hitch in this method of procedure and that is the legal aspect of this surplus which was acquired at the time of consolidation. The statutes governing consolidations in some of the States provide that such earned surplus of the consolidated companies shall be earned surplus to the emerging or continuing corporation and is available for dividends. These are matters, however, with which the attorney for the company will be familiar, and he will undoubtedly take into consideration in the consolidation agreement. Most of the States today have statutes governing consolidations and mergers, and these will naturally be followed by the attorney in all agreements prepared by him.

There also appears to be a difference of opinion with respect to the treatment of earned surplus of companies merged into an acquiring corporation. Obviously, it seems fair that any earned surplus that was on the books of the acquiring corporation at the time of merger should remain the earned surplus of the company after the merger. However, there does seem to be some difference of opinion as to whether or not any earned surplus that existed on the books of the companies merged into the acquiring corporation should be included in earned surplus of the combined companies after the merger has been completed. There are two points of view to this. One of these has been definitely settled, and that is where a corporation acquires the capital stock of another corporation as of a given date, that any surplus existing on the books of the company acquired is surplus at date of acquisition and therefore capital surplus after the date of the merger. On the other hand, if the merger was effected simultaneously with the exchange of stock of the surviving corporation for the stock of the merged corporation all of the stockholders immediately after completion of the merger have a community of interest in the combined earned surplus of both companies. Therefore, many accountants feel that if a merger has been effected in this manner that the earned surplus of all the companies should be carried forward as the earned surplus of the combined companies.

We have another type of merger which brings up a difficult problem in regard to the treatment of surplus and that is where a company over a period of years has acquired the capital stocks of a number of subsidiaries and decides that they should be merged for economic or other reasons. This holding company may operate these subsidiaries for a number of years, and under its supervision and direction the subsidiary companies have accumulated substantial amounts of earned surplus. At the time of acquisition, however, there was also an accumulation of earned surplus. It is definitely settled that this earned surplus at the date of acquisition is to be treated as capital surplus of the holding company in consolidated statements and should be eliminated in consolidation against the investment of the holding company in the stocks of the subsidiaries. However, when the earned surpluses since the date of acquisition of the stocks of these subsidiaries are brought into the merger the question arises as to whether or not they should be treated as earned surplus of the combined companies. One point of view is that even in this case we have in effect created a new integrated enterprise and that the earned surplus should be divided into earned surplus prior to the date of the merger and earned surplus subsequent to the date of merger. I am inclined to lean toward the earmarking and disclosing of earned surplus before and after the date of such merger. I believe that the organization whose efforts produced that earned surplus should treat it as earned surplus after the merger has been effected. The other point of view is that all earned surplus of the merged companies acquired by the continuing or surviving corporation should be treated as capital surplus and that only the earned surplus of the continuing or surviving corporation should be treated as earned surplus. I do not agree with this point of view.

In the case of treatment of surplus in quasi-reorganizations, the American Institute of Accountants has issued Research Bulletin No. 3 setting forth what is considered to be appropriate procedure in connection with this type of reorganization. The general purpose, as stated heretofore, is to make a restatement of assets, capital stocks and surplus through readjustment and enable the company to relieve its future income account or earned surplus account of charges which would otherwise be made thereagainst. It should be made clear in the report to the stockholders what restatements are proposed to be made, what adjustments are contemplated and the formal consent of the stockholders should be obtained. Such readjustment should be presented in the form of a fair and conservative balance sheet as of the date of readjustment in which assets and liabilities should be so stated that no artificial credits will arise from realization of the assets or discharge of the liabilities. Furthermore, the readjustment of values should be reasonably complete, in order that there be no continuation of the circumstances which justify charges to capital surplus in the future. After the adjustment has been made the earned surplus account representing accumulative earnings after such adjustment should be dated, usually from the date on which formal consent of the stockholders is given. There may be some exceptions to this, but usually the earned surplus account should be dated as near as practicable to the date on which formal consent of the stockholders is given, and should ordinarily not be prior to the close of the last completed fiscal year. One of the major principles set forth in Research Bulletin No. 3 is that amounts to be

written off should be charged against earned surplus to the full extent thereof and that the balance may then be charged against capital surplus. Likewise, a company that has subsidiaries should apply this rule in such a manner that no consolidated earned surplus will be carried through a readjustment in which some losses have been charged to capital surplus. If the earned surplus of any such subsidiaries cannot be applied against the losses before resort is had to capital surplus, the parent company's interest therein should be regarded as capitalized by the readjustment just as surplus at the date of acquisition, so far as the parent is concerned. One thing that should be avoided is an understatement as at the effective date of the readjustment of assets which are likely to be realized thereafter. Such understatement may result in conservatism in the balance-sheet at that date, but may also result in an overstatement of earnings or of earned surplus when the assets are subsequently realized. Therefore, the general rule is that assets should be carried forward as of the date of readjustment at a fair and not unduly conservative value, determined with due regard for the accounting rules to be employed by the company thereafter. Where a fair value of any asset is not readily determinable a conservative estimate may be made, but in that case the item should be described as an estimate and any material difference in value subsequently shown (by realization or otherwise) to have existed at that date should not be carried to earned surplus. If potential losses or charges are known to have arisen prior to the date of readjustment but the amounts thereof are then indeterminate, reserves may properly be made to cover the maximum probable losses or charges. If the reserves are subsequently found to be excessive or insufficient, the difference should not be carried to earned surplus nor used to offset gains or losses originating after the readjustment, but should be carried to capital surplus. When the readjustment has been completed, the company's accounting should be substantially similar to that appropriate for a new company. After such readjustment as already stated, previously earned surplus cannot properly be carried forward under that title. A new earned surplus account should be established, described as from the effective date of the readjustment. Capital surplus originating in such a readjustment is restricted in the same manner as that of a new corporation; in other words, it becomes subject to a previous rule issued by the American Institute of Accountants in 1934 which reads as follows:

> "Capital surplus, however created should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made there against. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to, and the action as formally approved by, the shareholders as in reorganization."

Charges against capital surplus should be only those which might properly be made against the initial surplus of a new corporation. Obviously, it is recognized that charges against capital surplus may take place in other types of readjustments to which the foregoing provisions would have no application. Such cases would include readjustment

for the purpose of correcting erroneous credits made to capital surplus in the past or to eliminate amounts which by universal agreement, do not give rise to charges in respect of exhaustion or amortization. In its statement the committee dealt only with that type of readjustment in which either the current income or earned surplus account or the income account of future years is relieved of charges which would otherwise be made there against. The existence of these different viewpoints in regard to surplus emphasizes the need for cooperative attention to these problems by the lawyers and the certified public accountants with the view of clarification which would give full consideration to the legal questions involved.

In the foregoing I have endeavored to present strictly accounting problems or issues as they would develop in giving consideration to the financial accounts of companies which may be parties to consolidations, mergers or reorganizations. There are two other factors which must be given careful consideration before determination can be made as to the wisdom of any proposed consolidation, merger or reorganization. The most important of these is whether or not the existing management of these companies has demonstrated its ability to continue to successfully manage these companies after consolidation, merger or reorganization. The other is that a study must be made to determine whether or not, even after consolidation, merger or reorganization, the companies can operate profitably. This requires a study of the existing products manufactured or sold by the companies, whether or not consolidation or merger will enable the company to make substantial savings in administrative, selling and other costs, which will improve the net profit result of such combinations and in the case of reorganizations whether the existing facilities are adequate for the manufacture, production and distribution of these products.

The current position of the company after completion of the consolidation, merger or reorganization is also of paramount importance to the successful continuance of the business. Therefore, when the current position has been determined after applying the foregoing adjustments, consideration must be given to whether or not the company will require additional cash funds to improve its current position and also for the purpose of making additions and betterments to the plant so as to increase the efficiency of its operations. Coincident with the determination of these requirements must be a plan for obtaining these additional funds either through short-term loans or through the issuance of long-term bonds or debentures, or the sale of additional preferred or common stocks. Obviously, if the company does not have sufficient funds to meet its current obligations it cannot hope to succeed, regardless of what adjustments may have been made in the process of reorganization. The studies in this connection should be based not only on past performance, but on future prospects and any estimates made should be conservative.

One may consider these problems as being essentially in the field of business management. It is obvious, however, that both lawyers and certified public accountants can contribute valuable guidance in resolving the business issues involved and in analyzing the relevant evidence based upon the past performance and present position of the corporate entities about to be reorganized. By cooperating together on these problems, the members of both professions can better serve their clients and the public interest.

Corporate Consolidations, Reorganizations and Mergers

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Presented June 7, 1945 for the Course on Current Problems in Accounting for Lawyers given by the Practicing Law Institute in cooperation with the American Institute of Accountants and the New York State Society of Certied Public Accountants.

THE subject of this evening's discussion is extremely broad in scope. It covers the accounting problems inherent in two very different economic situations—first, the process by which two or more healthy businesses are integrated and, second, the process by which a business may be extricated from financial difficulties. Most of the accounting work and principles involved in such transactions is identical with what is involved in the ordinary life of a business and needs no special emphasis. We are to deal instead with those accounting questions that are peculiar to the special situations mentioned.[1]

First, we may consider the accounting issues involved in the combination of two or more healthy businesses. There is some tendency to assume that specific accounting results follow automatically from the selection of a particular method of combination. For example, it is frequently argued that in a true merger there is no basis for departing from the carrying values appearing on the books of the predecessors, whereas in a combination by purchase of assets it is necessary to determine and impress on the acquiring company's accounts its cost of the assets and business acquired, whatever may be the carrying value on the other company's books. Similarly, where the combination is effected by acquisition of a controlling stock interest, it is sometimes stated that no change need be made in the carrying values of the new subsidiary's assets.

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The difficulty with attaching any fixed accounting result to the use of a particular form of combination is that the method of combination is frequently chosen on the basis of legal or practical considerations having little or no accounting significance. Founding a whole series of accounting differences on the mere fact that company A technically buys B's assets instead of merging with B scracely seems to me to be a sound approach. There are, of course, some accounting results which necessarily result from the choice of a method of combination. Clearly, for example, if combination is effected by acquiring stock control, the accountant must,

[1] The opinions expressed are those of the writer and are not necessarily representative of official rulings of the Commission. Moreover, it is intended not to deal with companies whose rates and accounts are subject to the jurisdiction of governmental regulatory agencies since in such circumstances there are a number of complicating factors to which consideration must be given.

of course, recognize that there are still two corporations.

The converse is also true. Not all combinations that technically are mergers are by that token homogeneous from a business point of view. For example, in one case two wholly unaffiliated corporations may be united by merger. In another, one of the constituents may be a wholly owned subsidiary of the other. In a third, one company may be newly organized for the sole purpose of merging with a single established company. All of these may technically be mergers, but economically and also accountingwise they are scarcely related.

From an accounting and business point of view, then, it seems to me that the particular technique of combination is very often of relatively minor significance. Much more weight, I think, should be given to such factors as the following as criteria or tests of the accounting to be followed:

(1) The relative size of the predecessors; that is, is one company so much larger than the other that it is obviously buying up a business rather than truly merging.

(2) The degree of affiliation among the predecessors.

(3) The extent to which there is a change in ownership in the course of the combination.

(4) The nature and extent of prior business relations between the two companies.

Perhaps all four of these criteria are directed ultimately to fixing the answer to this sort of question: Is the merger, consolidation or other form of combination in truth the organization of a really new economic enterprise, or is this in reality the continuance of the old business in a new corporate vehicle, perhaps with a new or somewhat expanded line of products?

The significance of such factors may be illustrated by examining the question of whether the combined company may have an earned surplus as of the date of combination, or whether it ought to consider any excess of assets over stated capital as capital surplus, and start anew the accumulation of an earned surplus. Let us assume that Companies A and B, each having an earned surplus, merge or consolidate or that one purchases the assets of the other. Our question is, may the surviving or new company start with an earned surplus equal to the earned surplus of one or all of the old companies.

Accounting authorities and existing practice do not agree on this question:

(1) Some authorities insist that earned surplus cannot survive a company and cannot be transferred to another company, hence only the earned surplus of a continuing entity is permitted to go forward.

(2) Others maintain that if the surviving or new company is in effect a continuation of both of the old companies it is entitled to an earned surplus equal to the sum of the earned surpluses of the old companies. This result is frequently said to be permissible only if a high degree of affiliation existed between the old companies.

(3) Some would permit earned surplus to survive or not, depending on the legal procedure — i.e., upon merger or possibly consolidation it would be permissible, but not as a result of purchasing assets for cash or stock.

(4) Others would prohibit any earned surplus if the effect of

the transaction is the creation of a new economic entity.

In my opinion, it is not ordinarily sound in the case of a merger or consolidation to carry forward, as earned surplus of the surviving company, the earned surplus of any company whose existence is terminated. Indeed, where the amalgamation in effect brings into existence a new business or economic enterprise, it is to be doubted whether any earned surplus, even that of a corporation which legally "survives", should be carried forward as earned surplus. There would, of course, be no objection to designating the surviving surplus as "Capital surplus — consisting of the earned surplus of consolidated or merged predecessors." Not to take this position would mean that:

(1) A company by, in effect, a purchase of assets can "make a profit", i.e., increase its earned surplus.

(2) The incongruous result is attained of permitting a company to "start out" with an earned surplus. Clearly, if the merged company occupies a substantially different competitive or bargaining position than its several predecessors, there is something incongruous in measuring the success of the new business by the accumulated earnings of the old business.

In this connection we may note the widely accepted quasi-reorganization principle of not permitting any earned surplus to survive the effective date. Moreover, if the combination is effected by acquisi tion of control, not even in the preparation of consolidated statements would a subsidiary's surplus at acquisition be considered as earnings to the parent or to the consolidation.

Finally, as I have suggested, not too much stress should be laid on the precise legal steps taken to effect the amalgamation—i.e., purchase of assets, merger, consolidation, or acquisition of stock followed by merger, consolidation, or, indeed, merely liquidation. If this position is not taken, then merely by choosing a certain *legal* method, e.g., purchase of assets instead of merger, one is permitted with unlimited discretion and without regard to economic facts,

(a) to decide whether any earned surplus shall survive, and

(b) to select the company whose earned surplus is to survive.

Consider a proposed combination of A Company, which has a $1,000,000 earned deficit, and B Company, which has an earned surplus of $1,500,000. The choice without regard to any economic considerations would exist of going forward with:

(1) No earned surplus or deficit

(2) Earned surplus of $1,500,000

(3) Deficit of $1,000,000 and

(4) Earned surplus of $500,000

One argument is so often heard that it may be worth special attention. It occurs in any case where substantially all old stockholders continue as stockholders of the surviving or new company. The argument is that since each stockholder had an interest in the earned surplus of his company he is entitled to have an interest in earned surplus after the merger. Or, as it is often put, since the old surplus was applicable to the old stockholders as a group, and since the group is not changed, then therefore the earned surplus should not be lost or changed. This argument seems to me unsound, or at best of some merit only in the very rare case where the per share interest in earned surplus is the same for both old companies. If this is not the case, a definite *transfer* of interest takes place and it is hard to see how the stockholder whose interest in earned surplus increases can consider he has gotten earnings. Take,

for example, the following case of merger or consolidation between A and B wherein on a combined earnings and asset basis one new share is issued for each share held in either old company:

	A Company	B Company	Surviving Company
Average earnings	$ 160,000	$ 140,000	—
Capital stock			
Pal value $100	1,000,000	1,000,000	$2,000,000
Earned surplus	500,000	1,000,000	1,500,000
Per share interest in earned surplus	$ 50	$ 100	$ 75

It is difficult for me to believe that a representation of $75 per share interest in accumulated earnings is at all realistic or even useful.

To summarize my own approach to this problem of when earned surplus may survive, the following conclusions may serve as a basis for further discussion:

1. Upon merger, consolidation, or other form of amalgamation of unaffiliated companies, earned surplus of all predecessors should prima facie be treated as capital surplus of the resulting company.
2. If, however, the size of one company is relatively so small that the other company obviously dominates the situation, then the earned surplus of the dominant company may survive.
3. Upon the amalgamation of two companies which are wholly-owned subsidiaries of the same parent, the surviving company may start with an earned surplus not in excess of the combined earnings since acquisition.
4. Upon the amalgamation of two companies which are parent and subsidiary, the surviving company may start with an earned surplus not in excess of consolidated earnings.
5. Where the companies are closely affiliated but there exists in the subsidiary a material minority interest, or an issue of prior stock, the general principle should be followed except that in the case of the amalgamation of two subsidiaries, the parent should be permitted to take up in consolidation the same amount of earnings as before the transaction.

In discussing the question of carrying earned surplus through a combination, I have assumed that no problem of asset valuation was presented. Mr. Marvin plans, I believe, to discuss that problem rather thoroughly and for that reason I shall refer to only one or two special situations. In recent years there have been a considerable number of cases in which a company acquired a going business through issuance of its own stock therefor. For the most part, such cases have not in my view represented a real merging of two businesses; but, largely because of the relative sizes of the two concerns, have instead reflected the outright addition by purchase of a small business by a large one. Technically most of such cases take the form of a purchase of assets for stock or of the acquisition of stock followed by a merger. There is seldom a question of adding the earned surplus of the acquired company to that of the purchaser. Instead, the issue is generally whether the assets acquired may or must be revalued, and whether in the process an intangible in the nature of good will is revealed and must be recorded. Ordinarily such

deals appear to be arranged on a mixed basis involving recognition of relative earning power, tangible assets, market value of securities, and perhaps factors of opportunity value, competitive position and even nuisance value. As the two businesses approach each other in size there is, of course, less to be said for the conclusion that either is "acquiring" the other. But assuming a disproportionate size, the generic facts are customarily these:

(1) The "fair value" of the stock being issued is determined at a given figure through judicious reference to market values, earning power and other factors.

(2) The fair value so determined is in excess of both the book and, we may assume, reasonable appraised value of all tangible assets plus clearly definable intangibles such as patents.

In such circumstances the question is raised whether the acquiring company must record its stock at its fair or actual value on issuance or whether it may record it at no more than an amount equal to the fair value of the *tangible* assets acquired. To follow the latter course is to permit a company, as I see it, to evade the responsibility of accounting for all that was actually acquired by it. But otherwise, it would permit a company to acquire a valuable asset and then immediately write it off to capital surplus. If the asset in question were tangible there are few who would countenance its deliberate and material undervaluation on the books of the acquiring company. If it were acquired for cash there are few today who would permit its elimination against any account other than earnings or earned surplus. Moreover, in the case of an intangible acquired for cash, the Commission indicated in the Associated Gas case (and re-emphasized its view in Accounting Series Release No. 50) that any charge-off must go against earnings or earned surplus and not capital surplus. In such cases as those in question here, I would regard the issuance of stock as a cash or cash equivalent transaction, would insist upon the recording of the intangible and would disagree with a proposal to eliminate it against capital surplus. It seems to me this view is strengthened by the fact that the same end result is reached whether we start by seeking to determine the "cost" of what is acquired or whether we look to see what the consideration received for the stock being issued ought to be.

A contrary result is, to my mind, reached if the combination is actually a family affair as is the case where a strong degree of affiliation exists between the two companies. In such cases there seem to me a good deal more danger than advantage in seeking to recognize a goodwill element. In such cases, the absence of any real arm's-length negotiation would leave any creation or recognition of intangible values in much the same case as if there were a direct write-in of goodwill on a company's own books.

One problem that has not been fully explored, or, indeed, very often raised, to my knowledge, is whether or not the survival of earned surplus and the recognition of new values for assets are inconsistent. It would seem, at first thought, at least, that if the factors tending toward continuity are sufficiently strong to justify the survival of earned surplus, they ought at the same time to be so strong as to preclude recognition of new values. Or put otherwise, only such new values should be recognized where earned surplus is carried forward as could be recognized and credited to earned surplus whether or not the combination was effected.

Before leaving the subject of combining going concerns, I think it may be helpful to point out that in one form of combination pretty definite accounting practices have been agreed upon. I have in mind the blending of two businesses that is accomplished when one company acquires the stock of the other. It seems pretty generally true that the amount at which the investment is to be set up on the new parent's books is ordinarily the cash cost, or, if the consideration was not cash, the fair value of the consideration given. There is also a growing tendency, where complete control is acquired, to review and adjust the carrying values of the assets of the underlying company so that a clear distinction is drawn between payments for increased or unrecorded value of tangible assets and payments for goodwill. In no case is there an attempt—absent prior close affiliation of the companies—to include in the parent's earned surplus or in consolidated earned surplus any earnings of the new subsidiary prior to acquisition of control. There is also very little effort and scanty authority for seeking to write off any part of the cost of the investment against capital surplus. This point does not, however, hold true in the preparation of consolidated statements although it seems to me inconsistent to raise no question as to the elimination of consolidated goodwill against capital surplus but at the same time to disapprove on an individual company's books the elimination of intangibles against such surplus. The point clearly merits careful study.

The second general category of cases is grouped under the general head of reorganizations. Loosely, that term is often used to refer not only to the revamping of companies or groups of companies in financial difficulties but also to adjustments of equity interests where no question exists as to the financial soundness of the enterprise. However, it is my intention to restrict this discussion to reorganizations designed to solve financial difficulties. In the more extreme cases, the problem ordinarily arises under the Chandler Act, as to which the Commission has a number of advisory responsibilities. Since reorganization under that Act usually involves the reduction or elimination of the interest of one or more classes of securities, it is apparent that the critical problem is one of valuation of the enterprise. The making of such valuations is not itself an accounting function although much of the raw material in the form of earnings statements is accounting data. And in the preparation of such data and its interpretation the accountant obviously has a great deal to do with the final result.

In the less extreme cases there is ordinarily no recourse had to the powers of a court for carrying out the needed reorganization. Instead, there has grown up in the last ten or fifteen years a rather considerable body of accounting principles underlying the procedure we call a quasi-reorganization that may be used where there are no questions of solvency. In brief, that is an accounting and financial device designed to enable a company to make a new start, without, however, the costly formalities that ordinarily attend a true legal reorganization. Basically, it is a matter of agreement among the affected shareholders, reached after full disclosure of the circumstances and marked by a formal consenting vote. Since both a formal and a quasi-reorganization are designed to handle different degrees of substantially the same business problem, the accounting issues involved are also much the same and can be discussed together.

The fundamental accounting principle is that a clean break must be

made with the past. To do this, great care must be taken that losses and profits fairly applicable to past operations are provided for or recognized in such a way that they will not at some later date be taken up as losses or profits of the period after the reorganization. Fundamentally this is again a question of a fair valuation. Obviously, such a valuation or revaluation must cover all assets and liabilities of the enterprise. It is not intended as a means by which to recognize merely a few selected losses.

On the other hand, the values carried forward, for which the new enterprise is to account, must not be set too low, for to do so would unduly benefit future operations. It would clearly be misleading, for example, to write inventories or plant down to $1 where on any reasonable basis their fair values were considerable. It would obviously be misleading in the future in such a case to count as "profits" everything received for inventories in excess of $1. It would be equally deceptive to compute future "profits" without any charge for utilization of the plant.

In practice, of course, it is rarely possible to settle upon a "fair value" that is fully provable and not subject to attack. The best that can be done is to settle upon what under all the circumstances and giving appropriate weight to conflicting evidence seems to be the fair value of the assets. The essence of such a procedure, however, is that once the revaluation is made it should be regarded in the future in the same light as would cost. Very occasionally there will be found cases where after the reorganization it is clear that the reorganization figures were arrived at on the basis of data that was at the time of reorganization incomplete or erroneous. Correction is then, and only then, in my judgment, appropriate. Great caution must be observed that losses truly applicable to operations after the reorganization are not in the guise of "corrections" thrown back, thus unjustifiably improving subsequent operating results.

This accounting basis of a reorganization is, it seems to me, pretty clear cut and understandable in principle. It is not so easy to apply it properly to some of the details or special situations that arise in actual cases. If, however, the objective is kept clearly in mind—to assign to the future only those costs and profits truly applicable to the future—a sound and reasonable solution to most questions will be reached. A few illustrations of some actual reorganization problems may be of assistance.

1. A company sought to establish a reserve to which would be charged any loss suffered on the disposition (or collection, if a receivable) of any asset held at the date of the quasi.
2. A company sought to establish a reserve against which future development and exploration expenses would be charged.
3. A company sought to ignore for the present dividends declared on its portfolio of temporary investments and to plan to treat such dividends as income when received in cash after the quasi.
4. A company sought to ignore a pending claim by it for additional compensation, although it had received informal notification that such claim had been allowed.
5. A company sought to reflect certain temporary investments at cost although their ready market value was greatly in excess of cost and they were to be sold (and were sold) with in a month or so.

In all of these cases it seems to me apparent that the proposed procedures would have clearly and unjustifiably benefited future operations.

On the other hand, in the following cases the procedures proposed seem to me well designed to provide in the reorganization for losses and profits clearly applicable to the past:

1. A company determined to abandon within the next several months such of its plants as were determined on the basis of an outside engineering study to be over-costly in operation and provided a reserve to absorb any excess of the carrying value over salvage or sales value.
2. A company provided a reserve applicable to its property account against which it proposed to charge any excess of carrying value over cost as finally determined by a regulatory body to exist as of the reorganization date and required to be written off.
3. A reserve was provided for possible additional assessments of taxes applicable to prior years.
4. A company retained an investment in a subsidiary at cost but indicated in a footnote that if the investment were required to be sold by a regulatory body, profit or loss chargeable against future operations would be determined on the basis of a disclosed estimated fair value at date of reorganization.

To complete the list, let me cite one situation as to which the answer is not so clear. Suppose a company has preferred dividends in arrears and undergoes a quasi. Is it permissible to provide a reserve therefor so that the results of future operations may be relieved of the necessity of covering dividends, the basic right to which arose prior to the date of the quasi-reorganization? Or should such charges be assigned to the period in which accrues the income from which the dividend is finally paid?

The one common factor in all of these cases of reorganization is the existence of losses—either in the form of an operating deficit or in the carrying of assets at amounts far in excess of any reasonably foreseeable value. The accounting problem in reorganization or quasi-reorganization is thus essentially the overall determination of the portion of costs that have been sunk and lost and from which no future benefits are reasonably foreseeable. Such a determination and separation of the present from the past ought to be viewed as an extreme and violent form of medicine not to be taken casually and certainly not frequently To use such a procedure annually or where the accumulated net loss is minor in amount is about as justifiable as amputating a hand to avoid the pain of taking out a splinter.

There is one final problem that I think should be mentioned. Some have suggested that the quasi-reorganization procedure be expanded or adapted to take care of cases where the corporate assets are carried for one reason or another at amounts very much below their "real worth". Their catalog of possible cases include discovery of new resources, acquisitions at "bargain prices" due to tax or other considerations, and the existence of usable plants which have been entirely depreciated through operation of Section 124 of the Internal Revenue Code. Such proposals seem to have at least a faint family resemblance in a great many cases to the ideas prevalent some twenty years ago when, if memory serves, a new era had arrived in which values could only go up, and a prophecy of next year's profits was invariably regarded as more reliable than the fact of last

year's losses. The kernel of this proposal is a write-up of assets which to my mind is a basically different procedure than that of allocating costs between the past and the future. If a problem exists and a control procedure must be established, I suggest that the procedure ought to be developed on its own as an independent and fully integrated philosophy. It ought not, in my opinion, to be tacked onto the wholly different concept of quasis. Neither do I feel there should be an attempt initially to restate the principles of a quasi in such broadened language as to put write-ups and write-downs in the same pigeonhole.

STATE SOCIETY ACTIVITIES

Calendar of Events

September 18, Tuesday — Regular meeting of the Board of Directors.

October 8, Monday — 7:30 P. M. Regular meeting of the Society. Location: Waldorf-Astoria Hotel, Lexington Avenue and 49th Street, New York. Subject: To be announced.

October 8, Monday—Regular meeting of the Board of Directors.

Clients Entitled to Copies of Tax Returns

The following statement by the Committee on Professional Conduct was approved by the Board of Directors at a meeting held on June 21, 1945.

The Committee on Professional Conduct has received inquiries from former clients of members as to whether they are entitled to receive from their former accountants, file copies of tax returns or other documents prepared for submission to Federal, State or Municipal taxing or regulatory authorities, if they have at no time received such copies from the accountant during the course of the engagement.

It is the opinion of the Committee that the failure to provide copies of such returns is discreditable to the members concerned, embarrassing to business men and constitutes a violation of the final paragraph of the Rules of Professional Conduct as set forth in Article XVIII of the By-Laws.

In case an accountant has supplied a client or former client with copies which have been lost or mislaid by such client, it is the opinion of the Committee, that the accountant, upon request of the client, should supply copies of the returns and may make a reasonable charge for the actual time required to prepare the copies.

It is hoped that this general statement will make it unnecessary for the Committee to act on specific complaints.

Lubin Appointed to Board of Examiners

The Board of Regents has appointed Joseph I. Lubin as a member of the State Board of Certified Public Accountant Examiners for a full term of five years.

Mr. Lubin is a member of the accounting firm of Eisner & Lubin, a member of the New York State Society of Certified Public Accountants since 1934 and also the American Institute of Accountants.

Recently Governor Dewey appointed Mr. Lubin as a member of the State Commission on Pensions.

Formerly Mr. Lubin was a Special Deputy Chief Investigator with the War Production Board in charge of accounting problems. Mr. Lubin was appointed Chairman of a Committee formed to eliminate unnecessary questionnaires sent to industry by the War Production Board.

PROFESSIONAL COMMENT

NACA Elects Officers

NACA has announced that Frank Klein, Vice President of Worthington Pump and Machinery Corporation has been elected President of the National Association of Cost Accountants in a mail vote just completed. Philip J. Warner, a member of the Society was reelected Treasurer and the following members of the Society were elected as Directors: George L. Nohe, Maurice E. Peloubet, Charles H. Towns, and Rodney F. Starkey.

Experience Rating—Unemployment Insurance

The Division of Placement and Unemployment Insurance has sent a one page questionnaire entitled "Unemployment Tax Credit Reply Form" to all corporations, partnerships, and individuals who have been filing New York State Unemployment Insurance Returns. This form must be completed and filed on or before May 31, 1945.

The taxpayer, under regulations issued since the Unemployment Tax Credit Reply Form was mailed, is permitted to allocate bonuses paid in one quarter over actual period earned. For example, bonuses paid in December 1943 may be allocated over the four quarters of that year. Bonuses paid in July 1944 may be allocated over the period earned or the first, second and third quarters but must all be reported in the calendar year 1944 even though bonus period runs from July 1, 1943 to June 30, 1944. The amount of the tax credit for each employer may be increased by allocating bonus payments or other irregular payments of compensation as indicated.

About October 1, 1945 the Department of Labor will issue to each employer a tax credit which may be used to reduce the payment or payments due from employer for New York State Unemployment Insurance Tax computed at 2.7% on payrolls during the period from July 1, 1945 to June 30, 1946. The credit may be taken against payment due for the second, third or fourth quarter. Credit memorandum becomes worthless unless applied against payments due to the New York State Unemployment Insurance Fund for the period from July 1, 1945 to June 30, 1946.

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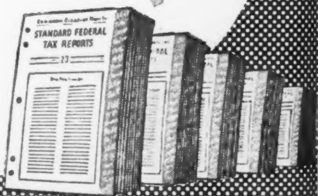

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